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No. 83-

In The

Supreme Court of the United States

October Term, 1982

DAVID METZGER TRUST,
JACOB METZGER, TRUSTEE,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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April 25, 1983

QUESTION PRESENTED

Whether evidence of family discord properly should be considered in mitigation of the attribution rules of section 318[1] in determining whether a redemption of stock is essentially equivalent to a dividend pursuant to section 302(b)(1)?

PARTIES BELOW

Appellants in the Court of Appeals were the David Metzger Trust, Jacob Metzger, Trustee, and Metzger Dairies, Inc. Metzger Dairies, Inc. has not joined in this Petition for a Writ of Certiorari. Appellee in the Court of Appeals was the Commissioner of Internal Revenue.

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[1]Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1954, as amended.

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

David Metzger Trust, Jacob Metzger, Trustee, petitions for Writ of Certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Tax Court, dated January 12, 1981, is reported at 76 T.C. 42 (1981) and is set forth in Appendix A. The opinion of the Court of Appeals, dated December 13, 1982, is reported at 693 F.2d 459 (5th Cir. 1982) and is set forth in Appendix B. The opinion of the Court of Appeals, dated January 26, 1983, on Petition for Rehearing and Suggestion for Rehearing En Banc is reported at 698 F.2d 1216 and is set forth in Appendix C.

JURISDICTION

The judgment of the Court of Appeals was entered on December 13, 1982, and its order denying the Petition for Rehearing and the Suggestion for Rehearing En Banc was entered on January 26, 1983. This petition is filed within ninety days of that denial. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1976).

STATUTORY PROVISIONS

The pertinent provisions of sections 301, 302 and 318 of the Internal Revenue Code of 1954, as amended, are set forth in Appendix D below.

STATEMENT OF THE CASE

This suit was brought on behalf of the Petitioner, David Metzger Trust, Jacob Metzger, Trustee (the "Trust"), a testamentary trust created by David Metzger for the benefit of his wife, Nora, and his three children, Jacob Metzger ("Jake"), Catherine Staacke ("Catherine") and Cecelia Jane Frew ("Cecelia"). Prior to the stock redemption hereinafter described, the Trust and the above-named beneficiaries held all of the outstanding stock of Metzger Dairies, Inc. ("Dairies").

Subsequent to the death of David Metzger in 1953, severe acrimony developed between Jake, Catherine and Cecelia which lead to the conclusion that Dairies could no longer be operated as a family business. In order to terminate the business and familial relations of these parties, Dairies redeemed, on or about January 22, 1973, all of its stock held by Catherine and Cecelia. In addition, Dairies likewise redeemed all of its stock held by the Trust because such stock would, under the terms of the Trust, pass to Jake,

Catherine and Cecelia upon the death of their mother, Nora Metzger.

The Trust treated the proceeds from the redemption of its Dairies stock as payment in exchange for such stock and reported the resulting gain as capital gain on its federal income tax return for the calendar year 1973. The Commissioner of Internal Revenue (the "Commissioner"), however, disputed such capital gain treatment and instead determined that the proceeds received by the Trust pursuant to the redemption should be taxed as ordinary (dividend) income to the extent of the earnings and profits of Dairies.

The Trust petitioned the United States Tax Court for a redetermination of the federal income tax deficiency proposed by the Commissioner for the calendar year 1973. In its petition, the Trust contended that the redemption of the stock of Dairies was not essentially equivalent to a dividend under section 302(b)(1).

Section 302(b)(1) provides that a redemption of stock will be considered as full payment in exchange for such stock, and thus subject to capital gain treatment, if such redemption is not essentially equivalent to a dividend. In determining whether a redemption is not essentially equivalent to a dividend, section 302(c)(1) provides that the constructive ownership rules contained in section 318, which attribute ownership of stock among certain related parties or entities, shall be applied. However, the application of the constructive ownership rules is not the only factor to be considered. Treas.Reg. § 1.302-2(b). Instead, in circumstances where extreme discord exists between the parties among whom stock ownership would otherwise be attributed, the courts, including the United States Court of Appeals for the First Circuit in *Robin Haft Trust v.*

Commissioner, 510 F.2d 43 (1st Cir. 1975), have recognized that the underpinnings of the section 318 attribution rules are not present, and thus family discord may be a mitigating factor in testing the dividend equivalence of a redemption.

In connection with the submission of the case to the Tax Court, the Trust and the Commissioner stipulated three critical facts: (i) the principal and primary reason underlying the redemption of stock of Dairies was the determination by Jake, Catherine and Cecelia that the hatred and discord existing between them necessitated the discontinuance of the operation of the corporation's business by these named individuals, (ii) the redemption was not principally or primarily motivated by an attempt to realize a profit on their stock in the corporation or to receive dividends undistributed from prior years, and (iii) both before and after the redemption in question, the discord and complete disharmony between Jake, Catherine and Cecelia was so extreme that they would not have acted in concert or for the benefit of each other in connection with the redemption of the stock of Dairies, its business policies and operations, or otherwise.

Notwithstanding the holding in *Haft* and other relevant authorities, the Tax Court upheld a deficiency in federal income tax in the amount of $187,037.80 for the calendar year 1973. The court determined that since, as a result of attribution from Jake, the Trust constructively owned 100 percent of the stock of Dairies after the redemption, the redemption was essentially equivalent to a dividend. Relying on this Court's decision in *United States v. Davis*, 397 U.S. 301 (1970), the court held that evidence of family discord should not be considered in determining whether a redemption was essentially equivalent to a dividend where the redeemed shareholder owned, actually or constructively,

100 percent of the stock of the redeeming corporation both before and after the redemption in question.

The Court of Appeals affirmed the decision of the Tax Court, specifically recognizing that its refusal to consider evidence of family discord in mitigation of the attribution rules in the context of section 302(b)(1) was in conflict with the decision of the First Circuit in *Robin Haft Trust, supra.* The Trust thereupon filed a Petition for Rehearing and a Suggestion for Rehearing En Banc, each of which was denied by the Court of Appeals.

REASONS FOR GRANTING THE WRIT

I. The Decision of the Fifth Circuit Created a Conflict Between the Fifth Circuit and First Circuit as to the Proper Application of Section 302(b)(1).

The instant case presents an opportunity for the Court to resolve a clear conflict between the circuit courts involving a question of substantial practical importance. The controversy concerns section 302(b)(1) of the Internal Revenue Code, which provides that a stock redemption will be treated as a sale of stock (and thus subject to capital gain treatment) if it is not "essentially equivalent to a dividend." As stated above, in determining the dividend equivalence of a redemption, the general rule of section 302(c)(1) requires that the constructive ownership rules of section 318 shall be applied.

The principal judicial decision regarding the application of section 302(b)(1) is this Court's decision in *Davis, supra,* wherein a corporation redeemed all of its outstanding preferred stock from a shareholder who, together with his immediate family, continued to own all of the corporation's outstanding common stock. This Court held that in order

to qualify for preferred treatment under section 302(b)(1), "a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation." 397 U.S. 301, 313. Since, under the facts presented (which did not entail the existence of family discord), the taxpayer constructively owned 100 percent of the common stock of the corporation both before and after the redemption, this Court concluded that the preferred stock redemption was essentially equivalent to a dividend. In this connection, the Court made the now often-quoted statement that the redemption of stock of a sole shareholder, including a "constructive" sole shareholder, is "always 'essentially equivalent to a dividend' " under section 302(b)(1).

Subsequent to *Davis*, the First Circuit was asked in *Robin Haft Trust, supra*, to apply section 302(b)(1) in a situation factually analogous to *Davis*, except that evidence of family discord was presented. There, in connection with a bitter divorce action, a corporation redeemed its stock owned by four trusts, the beneficiaries of which were the children of the hostile parties. As in the case of the David Metzger Trust, the four trusts in *Haft* did not actually own any stock of the redeeming corporation after the redemption; however, the application of the attribution rules resulted in an increase in the trusts' respective interests in the corporation after the redemption. The First Circuit concluded that such post-redemption constructive ownership was not determinative of the dividend equivalence issue, and that "family discord could belie the community-of-interest rationale of the attribution rules and was thus a relevant circumstance in determining dividend equivalency under [section 302](b)(1)." 510 F.2d at 46.

The First Circuit in *Haft* rejected the Tax Court's holding that *Davis* precluded consideration of family discord, particu-

larly since this Court was not presented with evidence of family hostility in *Davis*. Instead, the First Circuit interpreted the holding in *Davis* that the redemption must result in a "meaningful reduction of the shareholder's proportionate interest in the corporation" as permitting, if not mandating, "an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules." *Id.* at 48.[2]

The Court of Appeals in the instant case interpreted *Davis* differently. It held that, since the Trust constructively owned 100 percent of the stock of Dairies both before and after the redemption, such redemption of the Trust's shares must be treated as essentially equivalent to a dividend without consideration of family discord or other mitigating factors. Specifically, although recognizing that its decision would create a clear conflict among the circuit courts, the Fifth Circuit ruled that, pursuant to *Davis*, evidence of family discord cannot be considered in mitigation of the attribution rules in the course of a determination under section 302(b)(1).[3]

Accordingly, as evidenced by the conflicting decisions of the Courts of Appeals in the instant case and *Haft*, the confusion regarding the proper application of section 302(b)(1), which this Court sought to eliminate in *Davis*,

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[2]The First Circuit remanded the case to the Tax Court for a reconsideration of the facts and circumstances, "including the existence of family discord tending to negate the presumption that the taxpayers would exert continuing control over the corporation despite the redemption." *Id.* at 48. The case was subsequently settled, and thus no further opinion was issued.

[3]The Court of Appeals dismissed as dictum its statement in *Rickey v. United States*, 592 F.2d 1251, 1257 (5th Cir. 1979), that *Davis* had not precluded a consideration of family discord with respect to a determination under section 302(b)(1). 693 F.2d at 466.

has again reappeared. The Court should grant the writ in order to resolve this disarray among the various circuit courts.

II. There is a Pressing Need for Clarification of this Court's Decision in Davis so as to Permit Proper and Consistent Administration of the Tax Laws.

The decision of the Fifth Circuit in the instant case not only conflicts with the First Circuit's decision in *Haft*, it stems from a disagreement among the circuit courts as to the proper interpretation of this Court's opinion in *Davis*. Thus, while the very existence of a conflict among the circuit courts, which subjects litigants in different jurisdictions to differing legal principles, might in itself be a sufficient basis for review of this case on certiorari, only this Court can resolve a dispute that involves the proper interpretation of one of its own decisions.

The long-standing prevailing view of the proper interpretation of the *Davis* decision, and specifically, this Court's statement that a redemption of stock from a sole shareholder, including a constructive sole shareholder, would always be essentially equivalent to a dividend, has been that *Davis* does *not* preclude consideration of mitigating factors such as family discord in the application of section 302(b)(1).[4] This view as to the proper interpretation and application of section 302(b)(1) is in accord with views expressed by the Eighth Circuit and Ninth Circuit subse-

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[4]This view is supported by Treas. Reg. § 1.302-2(b) which provides, in pertinent part, as follows:

> (b) The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. *One of the facts to be considered* in making this determination is the constructive stock ownership of such shareholder under section 318(a). (Emphasis added).

quent to the *Davis* decision.[5] In addition, a substantial majority of such commentators, including Bittker and Eustice (described by this Court in *Davis* as the "leading commentators" in this area, and twice cited in that opinion), have advocated that this Court's decision in *Davis* did not eliminate the consideration of family discord in mitigation of stock attribution under section 318.[6]

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[5]*See, Wright v. United States,* 482 F.2d 600, 612 (8th Cir. 1973), where Judge Bright, in his dissenting opinion, stated:

> If the record in the present case revealed the exceptional situation where the interest of family-member shareholders (whose shares were attributable to the taxpayer) were *in fact* adverse to the taxpayer, I would be inclined to agree that the *Squier* case would be applicable here, and under its holding the taxpayer would have made a meaningful change in his interest through the redemption. However, the record before us provides no basis for assuming that the shares attributable to the taxpayer are held by shareholders with interests adverse to the taxpayer.

In addition, see *Title Insurance and Trust Co. v. United States,* 484 F.2d 462, 465 (9th Cir. 1973), where, after stating that the effect of the constructive ownership rules of section 318 is to attribute unity and entity to a family, the court stated:

> Such assumptions may, indeed, prove awkward or unfair in cases where families do not believe as the rules assume they will, and intra-family disputes exist as to who should control and how. However, we do not have such problems here.

[6]*See,* B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders,* § 9.24 at n. 73 (4th ed. 1979); O'Dell and Boyd, *Family Hostility and Stock Redemptions: Revenue Ruling 80-26 Revives the Controversy,* 59 Taxes 153 (March 1981); Englebrecht and DeCelles, *Family Discord and Section 302 Stock Redemptions: A Review and Analysis,* 58 Taxes 43 (January 1980); Bacon, *Corporate Stock Redemptions — Definitions; Basic Categories,* 343 Tax Mgt. A-75 (1978); Note, *Family Hostility as a Factor in Determining Constructive Stock Ownership in Corporate Redemptions,* 29 Tax. Law. 386 (1976); Randall and Benson, *Family Dissension and the Attribution Rules of Sections 267, 318 and 544,* 53 Taxes 534 (1975); Boyd and Boyd, *Family Discord May Negate Attribution Rules and Allow Capital Gain Treatment of a Redemption,* 15 Tax. for Accts. 362 (1975); Swennes, *"Not Essentially Equivalent to a Dividend" Exception Still Viable Despite Davis,* 41

In view of this long-standing interpretation of *Davis*, the conflict caused by the Fifth Circuit's decision in the instant case will result in confusion and uncertainty with respect to a continually recurring issue in the administration of the revenue laws affecting, among others, closely held corporations. Moreover, in the absence of a resolution of the conflict which now exists, the common occurrence of the events giving rise to the instant case will cause duplicative, expensive and needless litigation in the lower courts. Certainly, the cause of improved judicial administration will not be served by permitting the separate development of case law within each circuit, especially where, as here, a narrow issue of law is presented. Finally, resolution of the present conflict by this Court is necessary to establish a uniform, predictable and national standard as to the proper application of section 302(b)(1) which will guide both the Internal Revenue Service and interested taxpayers.

III. The Instant Case Provides an Ideal Vehicle for the Clarification by this Court of the Proper Application of Section 302(b)(1).

The instant case was submitted fully stipulated to the Tax Court with no factual issues remaining for determination. In particular, the Trust and the Commissioner have stipulated that the redemption in question was motivated by the extreme discord existing between Jake, Catherine and Cecelia and that, both before and after the redemption in question, such discord was so extreme that the parties would not have acted in concert or for the benefit of each

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J. Tax 78 (1974); *Contra*, Comment, *Section 318 — Family Hostility May Negate Application of Stock Attribution Rules to Section 302(b)(1) Stock Redemption. Haft Trust v. Commissioner, 510 F.2d 43 (1st Cir. 1975)*, 7 Rutgers — Camden L. J. 609, 613 (1976).

other. Accordingly, this case presents a simple, clear legal issue uncluttered by factual disputes. As such, it is an ideal case in which to determine whether family discord may be considered in mitigation of the attribution rules under section 302(b)(1).

Accordingly, Petitioner submits that this Court should grant the writ in order to clarify whether evidence of family discord can be considered in mitigation of the section 318 attribution rules with respect to a determination of dividend equivalence under section 302(b)(1), and thus resolve the conflict which currently exists between the Fifth Circuit and the First Circuit.

CONCLUSION

For the reasons stated, Petitioner prays that its Petition for a Writ of Certiorari be granted.

Respectfully submitted,

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April 25, 1983

DAVID METZGER TRUST, JACOB METZGER, TRUSTEE, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

METZGER DAIRIES, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 8824-77, 8856-77, 6990-79.

Filed January 12, 1981.

A brother and two sisters were shareholders in MDI and remaindermen in a trust which also held stock in MDI. Family hostility among the siblings caused MDI to redeem the stock owned by the trust and the two sisters. The trust was included in the redemption because under its terms, the stock it held in MDI would have passed to the remaindermen who were attempting to separate their business and family relations.

The trust complied with the prerequisites of sec. 302(c)-(2)(A), I.R.C. 1954, and filed an agreement purporting to waive the trust-beneficiary attribution rules of sec. 318(a)(3).

In partial payment of the redemption price, MDI executed a promissory note to one of the sisters. MDI claimed deductions for accrued interest expenses with regard to the note but did not actually make payment to the sister within 2½ months after the close of its fiscal years. Family hostility existed between the brother who owned more than 50 percent of the stock in MDI and the payee-sister. *Held:*

1. Family hostility does not nullify the attribution rules of sec. 318. The redemption was essentially equivalent to a dividend under sec. 302(b)(1). There was no complete termination of the trust's interest in MDI under sec. 302(b)(3). Thus, under sec. 302(d), the distribution is governed by sec. 301.

2. The agreement filed by the trust under sec. 302(c)-(2)(A)(iii) was ineffective to waive the trust-beneficiary attribution rules of sec. 318(a)(3). The trust may not treat the redemption of stock as a complete termination of a shareholder's interest under sec. 302(b)(3).

3. Family hostility does not nullify the attribution rules of sec. 267. MDI may not deduct accrued interest expenses paid over 2½ months after the close of its fiscal years.

Herbert S. Kendrick and *Don C. Stephenson,* for the petitioners.

Thomas G. Potts, for the respondent.

OPINION

DAWSON, *Judge:* In these consolidated cases respondent determined the following deficiencies in the Federal income taxes of petitioners:

Petitioner	*Docket No.*	*Year*	*Amount*
David Metzger Trust	8824-77	1973	$292,977.47
Metzger Dairies, Inc.	8856-77	1973	2,106.86
		1974	24,856.38
Metzger Dairies, Inc.	6990-79	1975	6,684.68

Because of concessions, the remaining issues for decision are:

(1) Whether family hostility among the shareholders of Metzger Dairies, Inc., who are also beneficiaries of the David Metzger Trust, nullifies the attribution rules of section 318[1] so that a redemption by the corporation of stock owned by the trust qualifies as an exchange under section 302(b)(1) or 302(b)(3).

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[1]All section references are to the Internal Revenue Code of 1954 as amended and in effect in the years at issue unless otherwise indicated.

(2) Whether a waiver agreement filed by the trust pursuant to section 302(c)(2)(A)(iii) was effective to waive the trust-beneficiary attribution rules of section 318(a)(3) so that the trust may treat a redemption of stock as a complete termination of a shareholder's interest under section 302(b)(3).

(3) Whether Metzger Dairies, Inc., may, notwithstanding section 267(a)(2), deduct accrued interest expenses owed to a cash method taxpayer but which were not actually paid until more than 2½ months after the close of its fiscal year where hostility existed between the payee and her brother, who owned more than 50 percent of the corporation's stock.

These cases were submitted fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure. The stipulations of fact and attached exhibits are incorporated herein by this reference. The pertinent facts are set forth below.

Jacob Metzger, Trustee of the David Metzger Trust (some times hereinafter referred to as the Trust) was a legal resident of Van Zandt County, Tex., when the Trust filed its petition herein. Metzger Dairies, Inc. (MDI), had its principal office in Dallas, Tex., at the time it filed its petition herein.

David Metzger formed MDI in 1946 to operate a dairy business in Dallas, Tex. He had earlier created the David Metzger Trust for his family, with his wife, Nora, as life income beneficiary, and his three children, Jacob Metzger, Catherine Staacke, and Cecelia Jane Frew, each as one-third remaindermen. This trust later became a shareholder of the corporation. After the death of David Metzger in 1953, Jacob assumed managerial control over MDI, installing himself as chairman of the board, and his son, David Metzger II (David II), as president, while Jacob's sisters, Catherine and Cecelia, were directors of the corporation. During the early years of Jacob's term as chief executive

officer, the corporation experienced financial success and was able to distribute dividends to its shareholders: Jacob, Catherine, and Cecelia, trusts established for each of them, Nora, and the David Metzger Trust.

During the 1960's, however, corporate earnings declined and dividends were not distributed. When this happened, Catherine and Cecelia became angry and on numerous occasions accused Jacob and his son, David II, of incompetent management; raising their already high salaries at a time when the corporation was unprofitable; spending too much time golfing, hunting, and fishing; and causing MDI to sustain substantial losses by its acquisition of another corporation solely to prevent a default by the latter on a promissory note owed to a Dallas bank of which Jacob was a director. Although Catherine and Cecelia were on the board of directors, they did not attempt to use their directorial voting power to change the management policy or to force a distribution of dividends because (1) Jacob as trustee of the David Metzger Trust voted and controlled its stock holdings in MDI, (2) they believed Jacob controlled the shares owned by their mother, Nora, by virtue of his ability to influence her decisions regarding the family business, (3) they were kept uninformed by Jacob regarding the business and thus lacked sufficient knowledge to suggest or demand corrective measures, and (4) Jacob threatened to use legal ploys to disinherit them from their father's trust should they attempt to overrule his managerial decisions and policies. As a result, Catherine and Cecelia found the meetings of the board of directors to be extremely unpleasant and distasteful.

Catherine also deeply resented Jacob because of his poor treatment of her son, Fred Staacke, Jr. (Fred Jr.). During the relevant years, Fred Jr. was president of Metzger Dairy of San Antonio, Inc. (MSA). This corporation was engaged in the dairy business in San Antonio, Tex., and its stock was owned, but for minor variations, by the same parties and in the same percentages as MDI. Although Fred Jr. was nominally president, his uncle Jacob perceived himself

to be the ultimate authority of MSA and proceeded to belittle Fred Jr.'s management, reverse his business decisions, make unannounced inspections, and complain about the company's profitability while refusing to assist in soliciting new customers. Catherine believed Jacob's persistent harassment and humiliation of her son drove Fred Jr. into alcoholism.

Cecelia held an animosity toward Jacob and Catherine because she resented the fact that, although MDI and MSA discontinued paying dividends, Jacob's family (through the employment by MDI of Jacob and David II) and Catherine's family (through the employment by MSA of Fred Jr.) continued to profit from the family businesses. On several occasions, Cecelia suggested that either MDI, Jacob, or Catherine buy her stock, but they refused on the grounds that a fair market value for the shares could not be determined. Sometime thereafter, Stop & Go Food Stores, Inc., an unrelated corporation, offered to purchase the stock of MDI, and Cecelia strongly urged that the offer be accepted. When the offer was rejected (or withdrawn for lack of acceptance), the enmity between Cecelia, on one side, and Jacob and Catherine, on the other side, was greatly aggravated. Cecelia became infuriated when she discovered that she had been purposely excluded from a meeting between them to make a determination as to their continued and future ownership of MDI and MSA. This was not the only occasion that pitted Cecelia against Jacob and Catherine. When the family was deciding to form the Mr. M Corp. of San Antonio, Inc. (Mr. M Corp.), to engage in the ownership and operation of retail convenience stores in San Antonio, Tex., Cecelia suggested it be formed as a wholly owned subsidiary of MDI. Instead, Jacob and his son, David II, and Catherine and her son, Fred Jr., decided the stock should be subscribed for and purchased individually. Because Cecelia was not employed by either of the existing corporations and received no dividends from them, she was financially unable to invest in the new business. Thus, when Jacob, David II, Catherine, and Fred Jr. thereafter profited from the success

of Mr. M Corp., Cecelia felt she had been betrayed by her brother and sister.

In addition to matters relating to the business of the three corporations, Jacob, Catherine, and Cecelia fought over other issues. Heated disputes constantly arose among them over whose family could use the family farm, a large estate containing a lake, recreational area, and multiple residences, which they owned in undivided interests along with their mother. In other instances Cecelia and Catherine, each being one-third remaindermen of the David Metzger Trust, accused their brother Jacob, the sole trustee, of mismanaging the trust corpus by investing it in securities which produced only minimal income. When they demanded the trust be turned over to a professional investment adviser, Jacob refused to relinquish his position.

Jacob had felt considerable resentment toward his two sisters since the occasion when their mother, Nora, decided to make gifts to her grandchildren of her principal estate. Jacob, having only two children, believed that Nora's estate should be divided into thirds and then distributed per stirpes to Catherine, Cecelia, and himself. Catherine, having three children, and Cecelia, having four, convinced their mother to distribute her estate per capita to the grandchildren.

In another incident, Cecelia, who lived in Oklahoma City, Okla., accused Jacob of failing in his responsibility of caring for their mother when she became of frail health. The feuding over this matter resulted in Catherine's moving their mother to a Houston, Tex., nursing home.

The rancor among Jacob, Catherine, and Cecelia struck a nadir in 1972 when Jacob accused Catherine and Fred Jr. of obtaining voting control of Mr. M Corp. by sharp and perfidious practices. Such passing of control occurred when Laura Metzger, upon her divorce from David II, received a portion of Mr. M Corp. stock owned by David II. David II believed that his former wife would quickly exhaust her cash resources and need more money, at which time he planned to reacquire the stock for a fraction of the value

at which he conveyed it to her. However, when Fred Jr. learned that Laura owned the stock, he schemed to acquire it first. Fred Jr. arranged for a business associate to procure the stock from Laura and to hold it for, and on behalf of, Fred Jr. as a nominee. The associate soon purchased Laura's stock with funds loaned to him by Fred Jr., who had borrowed the money from his mother, Catherine.

When Jacob and David II discovered the stock acquisition, they were incensed, believing they had been betrayed. Jacob immediately contacted Cecelia and Catherine and together they concluded that the business of MDI, MSA, and Mr. M Corp. could no longer be operated in the familial manner in which it had been in the past. After lengthy negotiations, they agreed that Jacob and his family would own MDI, Catherine and her family would own MSA and Mr. M Corp., and Cecelia and her family would receive cash compensation for their interests in such corporations. To accomplish this, they planned to cause MDI to redeem all its stock owned by Cecelia, Catherine, and the David Metzger Trust. The trust was included in the redemption because under the terms of the trust instrument, the stock it held in MDI would, upon the death of the life income beneficiary, Nora, pass in equal shares to the remaindermen who were attempting to separate their future business and familial relations. Pursuant to the plan, MSA and Mr. M Corp. redeemed their stock from all shareholders other than Catherine and her family.

The price at which each stock issue was redeemed was based on the price previously offered by Stop & Go Food Stores, Inc. Although Cecelia argued it was less than fair market value, she finally accepted such price "in order to get free of Jacob Metzger." Just when the redemption negotiations were about to be concluded, Jacob announced he would not sign the agreement unless Catherine and her children and Cecelia and her children all agreed to sell him their interests in the family farm at approximately one quarter of the then fair market value. This last minute de-

mand initiated bitter feuding, but in the end, the affected parties acquiesced in order to sever all ties of whatever nature with and among one another.

The trust and respondent have stipulated that (1) the principal and primary reason underlying the redemption of stock by MDI was the hatred and discord existing among Jacob, Catherine, and Cecelia, (2) the redemption was not principally or primarily motivated to realize a profit on their stock or to receive undistributed earnings from prior years, and (3) both before and after the redemption, Jacob, Catherine, and Cecelia would not have acted in concert or for the benefit of one another in connection with the redemption of the stock of MDI, the business policies and operations of MDI, or otherwise. On the date of the redemption, MDI had no current earnings and profits, but had accumulated earnings and profits of $1,815,060.77, of which 23.90889 percent was allocable to the distribution to the David Metzger Trust.

On or about January 22, 1973, the agreed-upon redemptions took place. As of January 1, 1973, MDI had outstanding 3,000 shares of common stock which were owned as follows:

Shareholder	*Number of shares*
David Metzger Trust	420
Nora Metzger	420
Jacob Metzger	600
Trust for Jacob Metzger	120
Catherine Staacke	600
Trust for Catherine Staacke	120
Cecelia Jane Frew	600
Trust for Cecelia Jane Frew	120
Total	3,000

Subsequent to the redemption, the remaining shares of stock then outstanding were owned as follows:

Shareholder	*Number of shares*
Jacob Metzger	600
Trust for Jacob Metzger	120
Trust for David Metzger II (son of Jacob Metzger)	294
Trust for Nan Metzger (daughter of Jacob Metzger)	207
Total	1,221

On February 10, 1976, Jacob, as trustee of the David Metzger Trust, delivered to an authorized agent of the Internal Revenue Service an agreement referred to in section 302(c)(2)(A)(iii) and section 1.302-4, Income Tax Regs. Subsequent to the redemption of all of its 420 shares, the trust has not acquired any MDI stock nor has it held any interest in the corporation as officer, director, or employee.

In partial payment for the 600 shares redeemed from Cecelia, MDI executed a promissory note to her in the amount of $627,110.53, payable in three equal annual installments, plus interest, beginning January 22, 1974. In accordance with its accrual method of accounting, the corporation claimed deductions for accrued interest expense with respect to the above-described promissory note in the amount of $32,167.28, $31,533.07, and $13,926.46 for its fiscal years ended September 30, 1973, September 30, 1974, and September 30, 1975, respectively. These interest expenses were not paid to Cecelia within 2½ months after the close of MDI's fiscal years. Rather, the amounts were paid on January 21, 1974, January 7, 1975, and January 5, 1976, respectively. Cecelia reported income in accordance with the cash receipts and disbursements method of accounting for the calendar years 1974, 1975, and 1976. Accordingly, the accrued interest expense in the amount of $32,167.28, claimed as a deduction by MDI for its fiscal year ended September 30, 1973, was included in income by her for the calendar year 1974. Similarly, the accrued interest expense in the amount of $31,533.07, claimed as a deduction by MDI

for its fiscal year ended September 30, 1974, was included in income by her for the calendar year 1975. The accrued interest expense in the amount of $13,926.46, claimed as a deduction by MDI for its fiscal year ended September 30, 1975, was included in income by her for the calendar year 1976.

Issue 1

The first issue presented is whether the trust is entitled to exchange treatment, under section 302, on a stock redemption caused by family hostility among the individual shareholders of the redeeming corporation, who were also beneficiaries of the trust. As a general rule, distribution of property by a corporation to its shareholders is treated, pursuant to sections 301 and 316,[2] as a dividend out of earnings and profits to the extent of such earnings. One exception to this general rule is made for certain distributions in redemption of a corporation's stock. Section 302(a) treats such distributions as "payment in exchange for the stock," taxable as capital gain, if the requirements of one of the four paragraphs of section 302(b) are met. The paragraphs relevant to this case are (1) and (3). Section 302(b)(1) makes section 302(a) applicable if the redemption is not essentially equivalent to a dividend. Section 302(b)(3) makes section 302(a) applicable if there has been a complete redemption of all of that corporation's stock owned by the shareholder. Section 302(d)

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[2]Under sec. 301, that portion of a distribution which is considered a dividend under sec. 316 is ordinary income; that portion which is not a dividend is treated as return of capital to the extent of the shareholder's basis in the stock; and any excess over basis is treated as gain from the sale or exchange of property.

On Jan. 22, 1973, MDI distributed $585,303.25 to the David Metzger Trust in redemption of 420 shares of MDI. On that date, MDI had no current earnings and profits under sec. 316, but it did have $1,815,060.77 of accumulated earnings and profits. The parties have stipulated that if the redemption were deemed, pursuant to sec. 302(d), to be a distribution to which sec. 301 applied, then $433,960.88 should be treated as dividend under sec. 301(c)(1), and $151,342.37 should be applied to reduce the basis of the stock held by the trust ($231,000) under sec. 301(c)(2).

provides that if a corporation redeems its stock and if section 302(a) does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

Section 302(c)(1) provides that, except as provided in paragraph (2), the attribution rules of section 318 shall be applied in determining the ownership of stock for purposes of applying the rules of section 302. Section 318(a)(1)-(A)(ii) provides, in part, that an individual shall be considered as owning the stock owned by his children. Section 318(a)(2)(B)(i) provides that beneficiaries of a trust shall be considered as owning the stock owned by the trust in proportion to their actuarial interest. Section 318(a)(3)-(B)(i) provides that a trust shall be considered to own the stock owned by its beneficiaries who have more than a remote contingent interest. However, under section 302(c)(2), the attribution rules of section 318 are not applicable where there is a complete termination of a shareholder's interest under section 302(b)(3), if certain conditions are satisfied, including the requirement that the distributee file an agreement to notify the Internal Revenue Service of any future acquisition of stock in the redeeming corporation. Sec. 302(a)(2)(A)(iii).

Respondent contends that the redemption was essentially equivalent to a dividend, and thus is taxable as a dividend under sections 302(d) and 301 because the trust, after application of the attribution rules, maintained a 100-percent ownership interest both before and after the redemption. Before the redemption, the trust owned 3,000 shares, or 100 percent of the stock of MDI. It owned directly 420 shares. In addition, it constructively owned, by reason of the attribution rule of section 318(a)(B)(i), the shares owned by its beneficiaries: Nora, 420 shares; Jacob, 600 shares; Catherine, 600 shares; and Cecelia, 600 shares.[3]

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[3]There have been no claims made that any beneficiary's interest in the David Metzger Trust is a remote contingent interest under sec. 318(a)(3)(B)(i).

Moreover, the trust also constructively owned 360 shares of stock which were held in separate trusts for Jacob, Catherine, and Cecelia. Section 318(a) (2) (B) (i) attributes the 120 shares in the Jacob Metzger Trust to Jacob, individually, the 120 shares in the Catherine Staacke Trust to Catherine, individually, and the 120 shares in the Cecelia Jane Frew Trust to Cecelia, individually; section 318(a) (3) (B) (i) then reattributes this stock constructively owned by the beneficiaries of the David Metzger Trust to the trust, itself.

At the redemption, the stock owned by the David Metzger Trust (420 shares), Nora (420 shares), Catherine (600 shares), the Catherine Staacke Trust (120 shares), Cecelia (600 shares), and the Cecelia Jane Frew Trust (120 shares) was fully redeemed. No stock owned by Jacob or the Jacob Metzger Trust was redeemed.

After the redemption, there were 1,221 outstanding shares of MDI. Respondent argues that all the shares were attributable to the David Metzger Trust. The 600 shares owned by Jacob are attributed to the Trust by section 318(a) (3)-(B) (i). The 120 shares in the Jacob Metzger Trust are attributed to Jacob by section 318(a) (2) (B) (i), and then from Jacob to the David Metzger Trust by section 318(a)-(3) (B) (i). In like manner, the 501 shares held in trust for Jacob's children, David II and Nan, are attributed to them by section 318(a) (2) (B) (i), and then from them to Jacob by section 318(a) (1) (A) (ii), and then from Jacob to the trust by section 318(a) (3) (B) (i). Thus, respondent contends that the David Metzger Trust also constructively owned 100 percent of the outstanding stock after the redemption.

The trust contends that the redemption was not essentially equivalent to a dividend, and thus qualifies as a distribution in exchange for the stock pursuant to sections 302(a) and 302(b) (1). This is so, the trust argues, because (1) the redemption was caused by extreme discord among the individual shareholders of MDI, (2) the stockholders

had no motive to realize a profit on their stock or to receive accumulated earnings and profits at capital gains rates, and (3) the hostility among the relevant parties was so severe that they would not have acted in concert or for the benefit of each other in connection with the redemption, or with regard to the business policies and operations of MDI.

Respondent also contends that the redemption failed to qualify as a complete redemption under section 302(b)(3) because ownership of the stock of the corporation individually owned by Jacob after the redemption should be attributed to the trust under section 318(a)(3). The trust has a two-pronged rebuttal to this. First, it contends that the stock should not be attributed to it because the redemption was occasioned by familial discord. Second, it argues that the exception to the attribution rules provided for in section 302(c)(2) applies to them because the trust complied with the requirements of section 318(c)(2)(A)(i) and (ii), and filed the waiver agreement specified in section 318(c)(2)(A)(iii).

We are once again confronted with the difficult question of whether a distribution, coupled with a redemption, of stock is "essentially equivalent to a dividend."[4] This is ordinarily a question of fact. *United States v. Fewell*, 255 F.2d 496 (5th Cir. 1958); *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973); sec. 1.302-2(b), Income Tax Regs. The leading case interpreting section 302(b)(1) is *United States v. Davis*, 397 U.S. 301 (1970). In the *Davis* case, Davis, his wife, son, and daughter each owned 25 percent of a corporation's common stock. In an earlier year, Davis purchased an entire issue of preferred stock for $25,000 to provide the corporation with sufficient capital to qualify

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[4]This problem has been called "exasperating," *Lewis v. Commissioner*, 35 T.C. 71, 76 (1960), "vexing," *Bradbury v. Commissioner*, 298 F.2d 111, 114 (1st Cir. 1962), "the morass created by decisions," *Ballenger v. United States*, 301 F.2d 192, 196 (4th Cir. 1962), and "nightmarish," *United States v. Fewell*, 255 F.2d 496, 499 (5th Cir. 1958); see also *Wilson v. United States*, 154 F. Supp. 341, 342-343 (N.D. N.Y. 1957), affd. 257 F.2d 534 (2d Cir. 1958).

it for a loan. Upon retirement of the loan, the corporation redeemed Davis' preferred stock for exactly his original investment, $25,000. Mr. Davis maintained the position that the attribution rules did not apply to a 302(b)(1) redemption, thus, the distribution was not pro rata on an *actual* ownership basis and hence not essentially equivalent to a dividend. He also claimed the redemption was occasioned by a valid non-tax-avoidance motive and a bona fide business purpose and thus should not be treated as a dividend.

In rejecting the taxpayer's arguments, the Supreme Court held: (1) The constructive ownership rules of section 318 apply to dividend equivalency determinations in section 302(b)(1); (2) redemptions of stock of a sole shareholder, including a "constructive" sole shareholder, are "always 'essentially equivalent to a dividend'" under section 302(b)(1); (3) business purpose is irrelevant in determining dividend equivalency under section 302(b)(1); and (4) in order to avoid dividend equivalency, the redemption must result in a "meaningful reduction in the shareholder's proportionate interest in the corporation."[5]

Respondent contends that (1) after application of the attribution rules, the trust was the sole shareholder of the corporation both before and after the redemption, (2) the non-tax-avoidance purpose of separating the business dealings of the feuding stockholders and members of the board of directors of MDI is irrelevant to the section 302(b)(1) determination; and (3) the redemption resulted in no meaningful reduction in the trust's interests in MDI.

The trust argues that if the attribution rules are not taken into account, it is not a sole shareholder before or after the redemption, hence the distribution would not be pro rata on an *actual* ownership basis, therefore not essentially equivalent to a dividend within the meaning of section 302(b)(1). It relies on *Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975), vacating and remanding 61 T.C. 398 (1973) and 62 T.C. 145 (1974) (supplemental opinion),

[5]See generally B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 9.24 (4th ed. 1979).

for the proposition that the existence of family hostility is a factor to be considered in the mitigation of the constructive ownership rules of section 318 in determining dividend equivalence under section 302(b)(1). The *Haft Trust* case concerned four trusts established by the maternal grandfather, one trust for each of the children of Burt and Marcia Haft. The sole asset of each trust was 25,000 shares of stock of Haft-Gaines Corp. Before the redemption, there were 500,000 shares of Haft-Gaines Corp. stock outstanding. Burt Haft owned 100,000 shares directly, 33,333⅓ shares constructively through a trust of which he was a beneficiary, and 100,000 shares constructively through four trusts set up for his children (the 25,000 shares of stock of each trust being attributed to each child, then reattributed from each child to Burt), for a total of 233,333⅓ shares, or approximately 47 percent of the outstanding shares. Each trust owned 25,000 shares directly, and 133,333⅓ shares constructively (by attribution from Burt of his directly and constructively owned stock to each child, and then from each child to his or her respective trust), for a total of 158,333⅓ shares or approximately 31⅔ percent of the 500,000 shares of outstanding stock.

As a result of bitter acrimony between Burt and Marcia Haft, divorce proceedings were begun. During the course of the divorce, it was decided to separate the direct financial interests of Burt's corporation from the trusts established by Marcia's father. Accordingly, the corporation redeemed all of the shares owned by each of the four trusts.

After the redemption, there were 400,000 shares outstanding. Each trust owned no shares directly, but owned 133,333⅓ shares constructively (again, by attribution of 133,333⅓ shares, owned directly and constructively by Burt, to each child, and then from each child to his or her respective trust), for a total of 133,333⅓ shares or 33⅓ percent of the 400,000 shares of outstanding stock. Because of the attribution rules, each of the four trusts owned more shares after the redemption of its directly owned shares than before the redemption.

The Commissioner determined the proceeds of the redemption to be essentially equivalent to a dividend because there had not been a meaningful reduction of each trust's proportionate interest in the corporation according to the rule of *United States v. Davis*, 397 U.S. 301 (1970). The trusts petitioned this Court arguing that attribution should not be applied when there has been a "family fight" and hostility exists among the members of the family. In holding against the taxpayers, we stated:

> A careful review of the opinion of the Supreme Court in *Davis* convinces us that the petitioners' argument is inconsistent with the statements and rationale of that opinion. Before the enactment of the 1954 Code, the attribution rules were sometimes applied, and sometimes not applied; to avoid that uncertainty, section 302 expressly made the attribution rules applicable for purposes of determining whether a distribution in redemption should be treated as a dividend. H. Rept. No. 1337, 83d Cong., 2d Sess., p. A96 (1954). The Court relied upon "the plain language of the statute" in concluding that the attribution rules were applicable. 397 U.S. at 306. The Court was obviously convinced that in enacting the rules of section 302, Congress sought to provide definite and specific rules and to avoid the uncertainties which had arisen under the earlier law.* * *
>
> If the applicability of the attribution rules depended upon the feelings or attitudes among the members of a family, it would then be necessary to inquire into whether there was hostility or animosity among them, whether such discord was serious, and whether it would actually or likely impair the ability of one member of the family to influence the conduct of other members. By the terms of the statute, the attribution rules are applicable irrespective of the personal relationships which exist among the members of a family, and an interpretation of the statute which made their applicability depend upon whether there was discord among the members of the family — or the extent of any such

> discord — would frustrate the legislative objective and would be clearly inconsistent with the language and the rationale of *Davis*. * * * [61 T.C. at 403].

The trusts appealed our decision to the First Circuit which analyzed the law differently. *Haft Trust v. Commissioner, supra.* The Court of Appeals interpreted our opinion in *Estate of Squier v. Commissioner*, 35 T.C. 950 (1961), as embracing the principle that family discord could belie the community-of-interest rationale of the attribution rules, and their earlier opinion in *Bradbury v. Commissioner*, 298 F.2d 111 (1st Cir. 1962), as approving it:

> While these attribution rules are generally applicable to § 302(b)(1), see, Thomas G. Lewis, 35 T.C. 71 (1960), their imposition is not inflexible and if it can be demonstrated that discord exists in a family relationship which would make attribution unwarranted, they will not be applied. Compare, Estate of Arthur H. Squier, 35 T.C. 950 (1961) with Herbert C. Parker, T.C. Memo. 1961-176 * * * [298 F.2d 111, 116-117 n. 7.]

It construed the *Davis* opinion as not requiring that the factual inquiry end after taking into account the attribution rules. The Court also relied on section 1.302-2(b), Income Tax Regs., for the rule that "one of the facts to be considered" in making the determination of dividend equivalency is the constructive stock ownership caused by section 318. It further interpreted the *Davis* requirement for dividend nonequivalency of a "*meaningful reduction* of the shareholder's proportionate interest in the corporation" (397 U.S. at 313; emphasis added), as permitting, if not mandating, an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules. 510 F.2d at 48. Finally, the appellate court thought that Congress in retaining the "essentially equivalent to a dividend" exception of section 302(b)(1) in the Internal Revenue Code, showed itself willing to tolerate some administrative and judicial inconvenience brought about by inquiries into

"the uncertain shifting quagmires of family relationships" for the sake of taxpayer equity. 510 F.2d at 48. On the basis of its analysis, the First Circuit reversed our decision and remanded it for reconsideration of the trusts' claims in light of the facts and circumstances of the case, including the existence of family discord tending to negate the presumption that taxpayers would exert continuing control over the corporation despite the redemption.

The attribution rules of section 318 came into the tax law with the enactment of the Internal Revenue Code of 1954. Their legislative history provides an illuminating background for our examination. In the report of the House Ways and Means Committee to accompany H.R. 8300 (March 9, 1954), the committee stated:

> SECTION 311. ATTRIBUTION OF OWNERSHIP [Now section 318.]
>
> Section 311 articulates the circumstances under which ownership of stock by one person shall for the purpose of the sections to which section 311 is specifically made applicable be attributed to such other person. The sections to which section 311 are applicable are the following: 302 * * *
>
> no specific statutory guidance is at present provided for stock ownership in the area of corporate distributions and adjustments. As a result the administration of provision such as section 115(g)(1) [now section 302(b)(1)] of existing law has become clouded with uncertainty by reason of executive application of rules of attribution of ownership. *Your committee intends, through section 311, to remove these uncertainties by providing in the bill precise rules for attribution where this is appropriate.*[6] * * * [Emphasis added.]

Regarding what is now section 302(b)(3), the committee further stated:

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[6]H. Rept. 1337, 83d Cong., 2d Sess. A96 (1954), U.S. Code Cong. & Adm. News 4234 (1954).

> A distribution in complete redemption of a shareholder's stock will also result in capital gain. To prevent evasion of the complete redemption test a shareholder is considered as owning stock held by members of his immediate family, or by partnerships, corporations and trusts which he controls. At the present time a possible opportunity for tax avoidance results where redemptions are effected in the case of family-owned corporations. To prevent tax avoidance, but at the same time to provide *definitive rules* for the guidance of taxpayers, your committee has provided *precise standards* whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his immediate family (or by partnerships, corporations, or trusts which he controls). * * * [Emphasis added.][7]

Before the Senate Finance Committee issued its report, it held hearings on the proposed House bill. The Section on Taxation of the American Bar Association filed a statement with the committee in connection with H.R. 8300 which advised:

> [Section 318] assumes a unity of action and of interest within the family which is frequently lacking, at least where dependency does not exist. It has been suggested, therefore, that the family should be limited to one's minor children, spouse and other dependants. It is the experience of practicing lawyers that one is consulted far more often with respect to family and partnership squabbles over property than on family plans to avoid income taxes.[8]

The Senate Finance Committee, in its report to accompany H.R. 8300, refused to amend the House bill to accord with the A.B.A. suggestion, stating:

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[7]H. Rept. 1337, *supra* at 36, U.S. Code Cong. & Adm. News 4061 (1954).

[8]Hearings on H.R. 8300 Before the Senate Comm. on Finance, 83d Cong., 2d Sess. (Part 1), 366 (Apr. 7 and 8, 1954).

Your committee retained, with modifications noted in (2) below, the following provisions of the House bill which revise existing law with respect to corporate distributions:

* * * * * * *

(h) Provide rules to indicate specific instances when, for purposes of preventing tax avoidance, a person shall be considered to own stock owned by a related person.

(2) CHANGES MADE BY COMMITTEE

* * * * * * *

A distribution in complete redemption of a shareholder's stock will also result in capital gain. However, in order to prevent tax avoidance, your committee follows the rules of the House bill whereby, under specific circumstances, a shareholder may be considered as owning stock held by members of his family (or by partnerships, corporations, or estates, trusts in which he has an interest). * * * [9]

The Senate committee further explained:

SECTION 318. CONSTRUCTIVE OWNERSHIP OF STOCK

This section describes the area in which although in fact transactions related to stock ownership are in connection with a specific individual, ownership of stock is deemed to be in the hands of persons other than the person directly involved. * * *

The area of constructive ownership includes members of the family, persons having interests in partnerships, estates, trusts, and corporations, such partnerships, estates, trusts, and corporations and stock held under an option.

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[9] S. Rept. 1622, 83d Cong., 2d Sess. (1954), 43-45, U.S. Code Cong. & Adm. News 4674-4675 (1954).

> In the case of trusts, a similar rule applies, i.e., the beneficiary or grantor is deemed to own his proportionate interest in the stock owned by the trust or estate and the trust or estate is deemed to own all of the stock owned by its beneficiaries or grantors.* * * [10]

The American Law Institute Tax Project, which had made suggestions in February 1954 relating to corporate distributions for the then-prospective Internal Revenue Code of 1954, wrote a summary of its follow-up work for the period 1956-58 wherein it stated:

> The stock redemption rules of Code section 302 refer to the redemption of all of the stock "owned" by a shareholder and to distributions disproportionate to the stock "owned" by shareholders. It has long been recognized that the substance of these sections could be defeated where the particular shareholder permitted some of the stock involved to be held by members of his close family or by corporations, partnerships, or trusts in which he had an interest. To meet this difficulty, the tax law has devised rules regarding the attribution of stock ownership. Under these rules stock so distributed among the family or placed in controlled entities is collected and reallocated to the basic shareholder. These rules of attribution rest on certain assumptions, as, for example, that one member of a family can control the stock owned by other members of the family, or rather that whenever the extent of the stock ownership of one member of the family is in issue, it is proper to regard that member as holding all of the shares possessed by the family. Similarly, a partner or a shareholder can be regarded as owning a pro rata portion of the stock held by the entity. *These assumptions obviously have a considerable factual basis in most situations. Further, the burden on tax administration and tax planning would be almost intolerable if*

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[10] S. Rept. 1622, *supra* at 252-253, U.S. Code Cong. & Adm. News 4890 (1954).

these assumptions were treated only as presumptions, with the final issue depending on the particular factual situation. [Emphasis added.][11]

Finally, the end product of the legislative process, the statute itself makes the application of the attribution rules mandatory:

> SEC. 318(a). GENERAL RULE. —For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—
>
> (1) MEMBERS OF FAMILY. —
>
> (A) IN GENERAL. —An individual *shall* be considered as owning the stock owned, directly or indirectly, by or for—
>
> (i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
>
> (ii) his children, grandchildren, and parents.
>
> * * * * * * *
>
> (2) ATTRIBUTION FROM PARTNERSHIPS, ESTATES, TRUSTS, AND CORPORATIONS.
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> * * * * * * *

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[11] S. Surrey, "Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project — American Bar Association Committee Study on Legislative Revision," 14 Tax L. Rev. 1, 50-51 (1958). See also F. Ringel, S. Surrey & W. Warren, "Attribution of Stock Ownership in the Internal Revenue Code," 72 Harv. L. Rev. 209-210 (1958):

> "These rules of constructive ownership rest on certain assumptions which are readily supported in the everyday conduct of affairs * * * *Tax administration would be severely handicapped if the rules applied only as presumptions; tax planning, moreover, would be hazardous if it depended on an analysis of the actual relationship in each case. Therefore these assumptions have evolved as statutory rules.* [Emphasis added.]"

(B) FROM TRUSTS. —

(i) Stock owned, directly or indirectly, by and for a trust * * * *shall* be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.

* * * * * * *

(3) ATTRIBUTION TO PARTNERSHIP, ESTATES, TRUSTS, AND CORPORATIONS. —

* * * * * * *

(B) TO TRUSTS.—

(i) Stock owned, directly or indirectly, by or for a beneficiary of a trust * * * *shall* be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest.

[Emphasis added.]

The language of the statute is clear.[12] Courts do not have the power to repeal or amend the enactments of the legislature even though they may disagree with the result; rather, it is their function to give the natural and plain meaning to the statutes as passed by Congress. *National Life & Accident Insurance Co. v United States*, 524 F.2d 559, 560 (6th Cir. 1975); *International Trading Co. v. Commissioner*, 484 F.2d 707, 713 (7th Cir. 1973); *Busse v. Commissioner*, 479 F.2d 1147, 1152 (7th Cir. 1973). Some commentators have suggested that it would be better to ignore the attributions rules where family discord is present.[13] But courts should not

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[12]Other cases have consistently applied the attribution rules of sec. 318. *Title Ins. & Trust Co. v. United States*, 484 F.2d 462 (9th Cir. 1973), affg. 326 F. Supp. 617 (C.D. Cal. 1971); *Fehrs Finance Co. v. Commissioner*, 487 F.2d 184 (8th Cir. 1973), affd. 58 T.C. 174 (1972); *Grabowski Trust v. Commissioner*, 58 T.C. 650 (1972); *Estate of Runnels v. Commissioner*, 54 T.C. 762 (1970).

[13]B. Bittker, "The Taxation of Stock Redemptions and Partial Liquidations," 44 Cornell L. Q. 299, 324 (1959); T. Moore, "Dividend Equivalency-Taxation of Distributions in Redemption of

attempt to rewrite statutes because they feel that the scheme Congress created could be improved upon. *United States v. Calamaro*, 354 U.S. 351, 357 (1957).

It is not the function of a Court to rewrite or amend a statute in the guise of construing it. It is the Court's duty to construe and apply the statute as it is written; and if this results in inequity to certain taxpayers, the fault lies in the statute itself and is beyond the power of the Court to correct. *Farmers Tractor & Equipment Co. v. United States*, 224 F. Supp. 391 (E.D. Ark. 1963), appeal dismissed 326 F.2d 971 (8th Cir. 1964). Congress might have added a greater family-fight exception to the attribution rules than it did when it eliminated, under section 318(a) (1) (A) (i), attribution from a spouse who is legally separated from the individual under a decree of divorce or separate maintenance, but it did not. Our judicial function is limited to applying statutes on the basis of what Congress has written, not what Congress might have written. *Youakim v. Miller*, 562 F.2d 483, 487 (7th Cir. 1977).

Although section 318 assumes, as the A.B.A. Section on Taxation pointed out to the Senate Finance Committee, a "unity of action and of interest within the family which is frequently lacking," a Court should not make an exception to a statutory rule on the basis of that Court's determination that Congress established the rule on the basis of a faulty set of assumptions. *In re Continental Investment Corp.*, 586 F.2d 241 (1st Cir. 1978).

The legislative history (*supra* p. 56) clearly shows the intention of Congress to provide "*definitive rules* for the guidance of taxpayers, [and] * * * *precise standards*

Stock," 19 Tax L. Rev. 249, 254-255 (1964); J. Boyd & M. Boyd, "Family discord may negate attribution rules and allow capital gain treatment of a redemption," 15 Taxation for Accountants 362 (1975); Note, "Family Hostility as a Factor in Determining Constructive Stock Ownership in Corporate Redemptions," 29 Tax Law. 386 (1976); Note, "Stock Redemptions From Close Family Corporations Under Section 302," 47 Minn. L. Rev. 853 (1963); A. Cohen, "Receipts Related to Corporate Equity: Return on Investment or Exchange?" 53 Taxes 824 (1975).

whereby under certain circumstances a shareholder may be considered as owning stock held by members of his immediate family (or by * * * trusts which he controls)." Congress sought to remedy the then-existing law which had "become clouded with uncertainty by reason of executive application of rules of attribution of ownership, * * * by providing in the bill *precise rules* for attribution where this is appropriate." (Emphasis added.) Only the most compelling demonstration of a contrary legislative intent could persuade this Court to ignore the plain words of the statute. *United States v. Le Beouf Bros. Towing Co.*, 537 F.2d 149, 152 (5th Cir. 1976). The legislative history of the attribution rules can hardly be called contrary to the plain words of section 318.

This does not mean that evidence of family discord is irrelevant to the question of dividend equivalency under section 302(b)(1). It does have a role, albeit limited. In the *Davis* case the Supreme Court analyzed Mr. Davis's stockholdings to determine if there had been a "meaningful reduction" of his proportionate interest in the corporation "*after* application of the attribution rules." *United States v. Davis*, 397 U.S. 301, 313. (Emphasis added.) Thus, the Court sets forth the order of analysis. First, the attribution rules are plainly and straightforwardly applied. Second, one looks to see if there has been a *reduction* in the stockholder's proportionate interest in the corporation. If not, as in the situation of Mr. Davis (who owned only 25 percent directly, owning the other 75 percent constructively through attribution from his wife, son, and daughter), then a Court need not proceed any further because there being no change in the stockholder's interest, dividend equivalency must follow.[14] If there has been a reduction, then a Court should proceed to examine all the facts and circumstances to see if

[14]As the Supreme Court stated:

"After application of the stock ownership attribution rules, this case viewed most simply involves a sole shareholder who causes part of his shares to be redeemed by the corporation. We conclude that such a redemption is *always* 'essentially equivalent to a dividend' within the meaning of that phrase in § 302(b)(1) * * * [*United States v. Davis*, 397 U.S. 301, 307 (1970). Emphasis added.]"

the reduction was *meaningful* for the purposes of section 302. At this point, family hostility becomes an appropriate factor for consideration.

Two arguments have been used to raise the family hostility factor prematurely in the process of determining dividend equivalency. The first involves a Treasury regulation; the second concerns the issue of corporate control. Section 1.302–2(b), Income Tax Regs., states:

> The question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a).

The regulation has been misinterpreted as meaning constructively owned stock could be disregarded under certain circumstances, such as family discord, in determining whether a meaningful reduction in the stockholder's proportionate interest in the corporation has resulted from the redemption. The calculation under this thesis must therefore relate only to the change in actual stock ownership. To treat constructively owned stock different from actually owned stock for section 302(b)(1) purposes would be the same as ignoring the attribution rules in the first place. This is clearly contrary to the plain meaning of the statute and its legislative history.

Some cases[15] and commentators[16] suggest that where family hostility exists, the concept of "interest" in a corporation can be broken down into two components, ownership

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[15] *Estate of Squier v. Commissioner*, 35 T.C. 950 (1961); *Parker v. Commissioner*, T.C. Memo. 1961-176.

[16] J. Boyd & M. Boyd, "Family discord may negate attribution rules and allow capital gain treatment of a redemption," 15 Taxation for Accountants 362 (1975); Note, "Family Hostility as a Factor in Determining Constructive Stock Ownership in Corporation Redemptions," 29 Tax Law. 386 (1976).

and control, for purposes of applying or not applying the attribution rules in determining dividend equivalency. Under such a theory a stockholder, who before the redemption owned 100 percent of a corporation, actually, and who after the redemption owned no stock, actually, but 100 percent, constructively, could be deemed to have no control over the corporation where the remaining shareholders were unfriendly section 318 relatives or entities. Because his "control" of the corporation went from 100 percent to nothing, the shareholder, according to the theory, had a meaningful reduction in his "interest" in the corporation. This, in effect, ignores the constructively owned stock for the purposes of determining dividend equivalency contrary to the statute, the regulations, the legislative history, and the rule of *Davis. Niedermeyer v. Commissioner*, 62 T.C. 280, 285-86 (1974), affd. 535 F.2d 500 (9th Cir. 1976), cert. denied 429 U.S. 1000 (1976). Although the degree of control of a corporation is a factor to be considered in testing dividend equivalency (*Benjamin v. Commissioner*, 66 T.C. 1084 (1976), affd. 592 F.2d 1259 (5th Cir. 1979)), the final determination must take into account constructively owned stock as well as actually owned stock. Such a position is consistent with the effect of attribution in situations where there is no family discord and where the taxpayer, after the redemption, owned no stock, actually, but 100 percent, constructively. In such cases, courts have held the distribution to be essentially equivalent to a dividend. *Lewis v. Commissioner*, 35 T.C. 71 (1960); *Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967), affg. 47 T.C. 258 (1966).[17]

Family discord can be a relevant fact to be considered in determining whether the reduction in the shareholder's interest is meaningful so as to qualify the distribution as not essentially equivalent to a dividend under section 302(b)(1). The Commissioner's revenue rulings pertaining to that section provide a convenient vehicle for illustrating the proper

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[17]See also *Title Insurance & Trust Co. v. United States*, 484 F.2d 462 (9th Cir. 1973).

role of such a fact. In Rev. Rul. 75-502, 1975-2 C.B. 111, the Commissioner determined that a redemption of an estate's 250 shares of common stock by a corporation, whose remaining 1,500 shares were equally divided between the estate's sole beneficiary and an unrelated individual, constituted a meaningful reduction of the estate's interest and was not essentially equivalent to a dividend under section 302(b)(1). The Commissioner explained that it was significant that the redemption reduced the estate's voting rights in the redeeming corporation from 57 percent to 50 percent, and also reduced the estate's rights to share in net assets on liquidation. Furthermore, the reduction of the estate's voting rights from 57 percent to 50 percent produced a situation in which the other 50 percent of the voting rights were held by a single *unrelated* shareholder. Had the stock been owned by a brother and sister of the beneficiary, who were not themselves beneficiaries of the estate, and whose stockholdings could not be attributed to the estate or to the beneficiary, the Internal Revenue Service could have argued that the siblings would act in concert, one for the benefit of the other. Thus, the fact that the estate's drop of 7 percent from majority interest to an equal interest might not be meaningful. Here, family discord would tend to show the "hostile relative" should be treated as an unrelated shareholder.

In Rev. Rul. 76-364, 1976-2 C.B. 91, the Commissioner determined that a redemption by a corporation of its outstanding common stock, which resulted in a 4.73-percent reduction of ownership of stock of a taxpayer who previously owned 27 percent of the stock, with the remaining 73 percent being held in equal portions (of 24⅓ percent each) by three unrelated persons, was a meaningful reduction of the taxpayer's interest in the corporation and was not essentially equivalent to a dividend. It was explained that the redemption not only reduced the taxpayer's interest from 27 percent to 22.27 percent (with a corresponding reduction in rights to vote, to earnings, and to share in net assets on liquidation), but also was *meaningful in itself* because it caused the redeemed shareholder to go from a position that afforded

him control of the corporation if he acted in concert with only one other stockholder, to a position where such action was not possible. If all four stockholders had been brothers and sisters, whose stock was not attributed one to another by section 318, the Internal Revenue Service could challenge the redemption on the grounds that the siblings acted in concert, one for the other, thus, although the taxpayer dropped from 27-percent ownership to 22.27 percent, there was no real change. Here, again, family hostility would tend to show that the redeemed shareholder once could have gained control of the corporation by acting in concert with only one sibling, but now was in a position where that was not possible.

In *Fehrs Finance Co. v. Commissioner*, 58 T.C. 174, 185 (1972), affd. 487 F.2d 184 (8th Cir. 1973), cert. denied 416 U.S. 938 (1974), we stated that, in dicta, there might be unusual circumstances where a 10-percent reduction in stock ownership, after attribution, would be material in determining whether there had been a meaningful reduction of the shareholder's proportionate interest. Here, again, family hostility would be a factor to be weighed in the facts and circumstances.[18]

We realize that the application of the law can produce harsh results in certain circumstances. Mr. Davis bought $25,000 of preferred stock so his corporation could qualify for a loan. After the loan was repaid, he sold the preferred stock back to the corporation at its original purchase price. Mr. Davis argued he had a capital gain of zero. Instead, the Supreme Court held he received $25,000 of ordinary income. While we can sympathize with the plight of such taxpayers, as Justice Douglas did in his dissent (*United States v. Davis*, 397 U.S. 301, 314), we observe the Supreme Court has been unwilling to reconsider the harsh effects of the *Davis* decision

[18]For a discussion of other facts and circumstances, see R. Swennes, " 'Not essentially equivalent to a dividend' exception still viable despite *Davis*," 41 J. Tax. 78 (1974). See also A. Cathcart, "Section 302 Redemptions: Family Fights and Attribution," 61 A.B.A.J. 1272 (1975).

(*Albers v. Commissioner*, 414 U.S. 982 (1973) (denying certiorari)), thus, we must follow the law.[19]

Accordingly, we conclude here that the redemption did not result in a meaningful reduction in the trust's proportionate interest in MDI for the purposes of section 301(b)(1). The trust's section 318(b)(3) argument rested on not applying section 318 to attribute the stock owned by Jacob to the trust after the redemption because of hostility among Jacob, Catherine, and Cecelia. Because family discord does not nullify the attribution rules, we hold that, except for the applicability of section 302(c)(2), the trust did not completely terminate its interest in MDI for the purposes of section 302(b)(3).

Issue 2

Next, we must decide whether the statutory exception to the attribution rules applies in this case. Section 302(b)(3) provides that a complete redemption of all the stock of the corporation owned by the shareholder will be treated as an exchange entitled to capital gains tax rates. Section 302(c)(2) provides:

> (A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—
>
> (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,
>
> (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or

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[19] *Tennessee Valley Authority v. Hill*, 437 U.S. 153, 195 (1978), the Supreme Court, in another statutory construction case, found that the following lines ascribed to Sir Thomas More by Robert Bolt were worthy of reflection.

"The law, Roper, the law. I know what's legal, not what's right. And I'll stick to what's legal. * * * I'm *not* God. The currents and eddies of right and wrong, which you find such plainsailing, I can't navigate, I'm no voyager. But in the thickets of the law, oh there I'm a forester

inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary by regulations prescribes, files an agreement to notify the Secretary of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

Respondent contends that the attribution rules contained in section 318(a)(3) apply to attribute to the trust all stock owned directly and beneficially by Jacob as well as the stock owned beneficially by Jacob's children, David II and Nan, which would be attributed to the trust through Jacob. Section 302(c)(2), respondent contends, does not apply because it allows only an exception to the family attribution rules specified in section 318(a)(1) and not the trust attribution rules specified in section 318(a)(3). In this contention, respondent relies on the language of the statute and our decision in *Johnson Trust v. Commissioner*, 71 T.C. 941 (1979), wherein we stated;

> Therefore, even though [the trust] waives the family attribution rules of section 318(a)(1) so that stock owned by [the beneficiary's] mother is not considered attributable to [the beneficiary], it has not waived, and cannot, under section 302(c), waive the provisions of section 318(a)(3)(B)(i) attributing to it stock owned by its beneficiary * * * [71 T.C. at 952.]

Because only the trust attribution rules of section 318(a)(3) have any application to this issue, it is those rules and not

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* * * What would you do? Cut a great road through the law to get after the Devil? * * * And when the last law was down, and the Devil turned round on you—where would you hide, Roper, the laws all being flat? * * * This country's planted thick with laws from coast to coast — Man's laws, not God's — and if you cut them down * * * d'you really think you could stand upright in the winds that would blow them? * * * Yes, I'd give the Devil benefit of law, for my own safety's sake. [R. Bolt, 'A Man For All Seasons', Act 1, p. 147 (Three Plays, Heinemann Educational Books, Inc. 1967).]"

the family attribution rules of section 318(a)(1), which operate to treat the trust as owner of the stock still owned after the redemption by Jacob.[20] Thus, respondent argues that the trust could report the redemption as a complete termination of its interest in MDI only if it could avoid the trust attribution rules of section 318(a)(3). Respondent contends that the trust has failed in this because, although it may have performed the prerequisites of the exception by having no other interest in the corporation other than a creditor (sec. 302(c)(2)(A)(i)), by not acquiring any such interest within 10 years from the redemption (sec. 302(c)(2)(A)(ii)), and filing an agreement to notify the Internal Revenue Service of any acquisition within the 10-year period and to keep necessary records (sec. 302(c)(2)(A)(iii)), the exception applies only to section 318(a)(1) and not section 318(a)(3).

To the contrary, the trust contends that the issue of whether the filing of a waiver is effective to waive the attribution rules of section 318(a)(3)(B) was resolved in its favor by the Court of Appeals for the Fifth Circuit in *Rickey v. United States*, 592 F.2d 1251 (5th Cir. 1979), which held that an estate had validly waived the estate-beneficiary attribution rule of section 318(a)(3)(A), so that a redemption of all the shares actually owned by the estate qualified as a complete redemption under section 302(b)(3).

In the *Rickey* case, the corporation had 2,255 shares of common stock outstanding before the redemption. The decedent had been president and principal stockholder of the corporation and his 1,292 shares (approximately 57 percent) passed to his estate. Another 788 shares (approximately 35 percent) were owned by the decedent's children. The balance, 175 shares (approximately 8 percent), were owned by unrelated shareholders. The company's articles of incorporation required that upon the death of a deceased

[20]No arguments were made that there was any hostility between Jacob and his children, David II and Nan, such that their stock should not be attributed to him under sec. 318(a)(1)(A)(ii).

shareholder, the corporation be offered the option to purchase his shares at book value. All of the shareholders viewed the provision as requiring the company to purchase the stock. This policy was designed to insure that corporate control was maintained by those who were active in the business. The decedent's will, moreover, directed his executrix to tender his stock to the company for redemption pursuant to the articles of incorporation. The will further named as residuary universal legatees the decedent's three children. In accordance with the will, the executrix offered all 1,292 shares to the company, which redeemed them a few months later.

After the redemption, the decedent's children still owned 788 shares which were now approximately 82 percent of the outstanding stock (963 shares). The remaining 175 shares, now approximately 18 percent of the outstanding stock, were held by unrelated stockholders. The estate treated the distribution as full payment in exchange for the stock, with no capital gain recognized because the basis in the stock had been stepped up, pursuant to section 1014, to the fair market value of the stock on the decedent's date of death. In the year following the redemption the estate was closed, and all of the assets, including the redemption proceeds, were distributed to the decedent's children, one-third to each of the estate's beneficiaries.

Upon audit of the beneficiaries, the Internal Revenue Service determined a deficiency on the grounds that the distribution was essentially equivalent to a dividend. The deficiency was paid. Thereafter, the estate was reopened and the executrix filed the agreement required by section 302(c)(2)(A)(iii) to notify the Internal Revenue Service of any acquisition by the estate of a prohibited interest in the company within 10 years after the redemption. After the Internal Revenue Service denied their claims for refunds, the beneficiaries filed a refund suit in the United States District Court. Following a decision for the taxpayers (427 F. Supp. 484 (W.D. La. 1976)), the Government appealed.

On appeal to the Fifth Circuit, the Government argued that, because of the attribution rules, the redemption of all of the stock actually held by the estate did not qualify as a complete termination of a stockholder's interest under 302(b)(3). This was so because the 788 shares (82 percent of the outstanding stock) owned by the decedent's three children who were residuary beneficiaries of the estate at the time of the redemption were still constructively owned by the estate under section 318(a)(3)(A) which provides in part, "Stock owned, directly or indirectly, by or for * * * a beneficiary of an estate shall be considered as owned by the * * * estate." The Government further maintained that the application of all of the constructive ownership rules of section 318 were required by section 302(c)(1), and that the exception in section 302(c)(2) applied only to the *family* attribution rules of section 318(a)(1) and not the estate-beneficiary attribution rules of section 318(a)(3).

The Fifth Circuit held the estate effectively waived the attribution rules of section 318(a)(3) in order to qualify for a section 302(b)(3) redemption. The Court of Appeals rested its holding on three grounds: (1) It believed application of the literal language of the statute would not bring about a result more in consonance with the intent of Congress in enacting the attribution and waiver sections; (2) it was convinced Congress intended and desired enforcement proceedings to be accompanied by commonsense and basic principles of fairness; (3) it rejected a "crabbed reading" of the Code where the rationale for applying the law was absent and where application of the rule leads to inappropriately harsh results. Thus, where the estate was merely carrying out the provisions of the decedent's will, the Court of Appeals concluded that the decedent's death was not "a device to bleed out corporate profits at capital gains rates." 592 F.2d at 1258.

With due respect for the views of the Court of Appeals, we nevertheless disagree with its reasoning. As discussed earlier, the intent of Congress in enacting the attribution rules was twofold, (1) to prevent tax avoidance, and (2)

to provide *definitive rules* and *precise standards* whereby attributions may be applied.[21] The Senate report gives an example of entity-beneficiary attribution which is analogous to the facts of both the *Rickey* case and this case.[22] That

[21]"A distribution in complete redemption of a shareholder's stock will also result in capital gain. To prevent evasion of the complete redemption test a shareholder is considered as owning stock held by members of his immediate family, or by partnerships, corporations and trusts which he controls. At the present time a possible opportunity for tax avoidance results where redemptions are effected in the case of family-owned corporations. To prevent tax avoidance, *but at the same time* to provide definitive rules for the guidance of taxpayers, your committee has provided precise standards whereby under specific circumstances, a shareholder may be considered as owning stock held by members of his immediate family (or by partnerships, corporations, or trusts which he controls)."

[H. Rept. 1337, 83d Cong., 2d Sess. 36 (1954), U.S. Code Cong. & Adm. News 4061 (1954). Emphasis added.]

[22]"Paragraph (3) (relating to termination of a shareholder's interest) corresponds to section 302(a)(3) of the House bill by providing that a distribution which is in complete redemption of all of the stock of a corporation owned by a shareholder shall be treated as a distribution in full payment for the stock of such shareholder. This paragraph must be read in connection with the provisions of subsection (c) of section 302 relating to constructive ownership of stock."

* * * * * * * * * *

"Subsection (c) of section 302, which corresponds in general to section 302(c) of the House bill, provides rules for determination of the constructive ownership of stock for the purpose of section 302.

"Paragraph (1) provides that the rules for constructive ownership of stock of section 318(a) shall apply for purposes of this section generally. *For example, if an individual owns half of the stock of a corporation, and a trust of which such individual is the sole beneficiary, owns the other half of such stock, a redemption of all of the stock of the corporation owned individually would not qualify under paragraph (2) or (3) of subsection (b). Under these circumstances, by reason of the application of section 318(a)(2)(B), such individual would be considered as owning all of the stock of the corporation, both before and after the redemption.*

"Paragraph (2) of subsection (c) provides special rules for application of section 318(a)(1) (relating to constructive ownership of stock between *members of a family)* in the case of a distribution in redemption under paragraph (3) of subsection (b) (relating to

example, set out in the footnote below, shows Congress contemplated applying the entity-attribution rules to preclude eligibility for section 302(b)(3) treatment; and the paragraphs following the example show that Congress was referring to "members of a family" when discussing the waiver exception under 302(c)(2). The other references which we have found in the legislative history discussing the 302(c)-(2) exception to the attribution refer only to family attribution, never entity-beneficiary attribution.[23] As we read the

termination of a shareholder's interest). Under subparagraph (A) of paragraph (2), it is provided that section 318(a)(1) shall not apply, i.e., stock owned by *members of the family* of the distributee would not be attributed to him immediately after the distribution in redemption, if the distributee himself has no interest in the corporation, including but not limited to an interest as officer, director or employee other than an interest as a creditor, and such distributee does not acquire such interest (other than stock acquired by bequest of inheritance) within 10 years from the date of distribution in redemption.

"Moreover, in order to qualify for nonattribution between *members of a family*, subparagraph (A)(iii) requires that the distributee, under regulations prescribed by the Secretary or his delegate, file an agreement to notify the Secretary or his delegate of any acquisition of any interest (other than by bequest or inheritance) within the 10-year period and to retain such records as the Secretary or his delegate may prescribe as necessary for the application of paragraph (2)."

[S. Rept. 1622, 83d Cong., 2d Sess. 235-236 (1954), U.S. Code Cong. & Adm. News 4872-4873 (1954). Emphasis added.]

[23]The rules of *family ownership* will not apply if the shareholder completely terminates his interest in the corporation and does not reacquire, other than by bequest or inheritance, an interest (other than an interest as a creditor), for a period of 10 years thereafter. * * * "

[H. Rept. 1337, 83d Cong., 2d Sess. 36 (1954), U.S. Code Cong. & Adm. News 4061 (1954). Emphasis added.]

"Subsection (c) makes clear that the rules of attribution of ownership provided in section 311 will be applicable in determining ownership of stock for the purpose of section 302. * * *

"Paragraph (2) of subsection (c) provides special rules for application of section 311(a) [now section 318] applicable solely to a distribution in redemption in termination of a shareholder's interest otherwise qualifying under paragraph (3) of subsection (a). It is intended by paragraph (2) and (3) to clarify the consequences of a complete redemption of a shareholder's interest where *family*

legislative history, we think the application of the language of section 302(c)(2) which provides an exception to the family attribution rules of section 318(a)(1) and provides no exception for the entity-beneficiary attribution rules of section 318(a)(3), would be consistent with the intent of Congress in enacting those sections.

While we agree with the Fifth Circuit that "Congress intended and desired enforcement proceedings to be accompanied by commonsense and basic principles of fairness," we are also mindful of the Supreme Court's warning on judicial restraint:

> Here we are urged to view the * * * Act "reasonably," and hence shape a remedy "that accords with some modicum of common sense and the public weal." * * * But is that our function? * * * Congress has spoken in the plainest of words, * * *

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ownership obtains so that the administration of this problem presently uncertain under section 115(g)(1) of existing law may be definitive.

"Subparagraph (A) of paragraph (2) provides that the rules of *family attribution* under section 311(a) shall not be applicable if immediately thereafter the distributee has no interest in the corporation (including an interest as an officer, director, or employee but not including an interest as a creditor) and under subparagraph (B) of paragraph (2) such distributee does not acquire any such interest in a corporation within 10 years from the date of the distribution in redemption. * * *"

[H. Rept. 1377, *supra* at A75, U.S. Code Cong. & Adm. News 4212 (1954). Emphasis added.]

"If a shareholder desires to sever completely his interest in a corporation which he and his family control, the *rules of family ownership* are waived, as under the House bill, if the shareholder does not reacquire, other than by bequest or inheritance, an interest (other than an interest as a creditor), for a period of 10 years thereafter. However, such a shareholder may not have made or received a gift of stock of the corporation, to or from his wife, for example, within 10 years prior to the distribution. If any interest is reacquired by a shareholder within the prohibited period, an additional tax may be recovered as if the original distribution had been a dividend. Thus modified the *family attribution* rules will be applied to insure a bona fide severance of a particular shareholder's interest in an enterprise and will not apply where there is no purpose of tax avoidance."

[S. Rept. 1622, 83d Cong., 2d Sess. 45 (1954), U.S. Code Cong. & Adm. News 4676 (1954). Emphasis added.]

> Our individual appraisal of the wisdom or unwisdom of a particular course consciously selected by the Congress is to be put aside in the process of interpreting a statute. Once the meaning of an enactment is discerned and its constitutionality determined, the judicial process comes to an end. We do not sit as a committee of review, nor are we vested with the power of veto. [*Tennessee Valley Authority v. Hill*, 437 U.S. 153, 194-195 (1978).]

The *Rickey* opinion has, in effect, added a new provision to the Internal Revenue Code.[24] Section 302(c)(2)(A) states, in part, "In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if * * * ." The Fifth Circuit has rewritten that provision to read "section 318(a)(1) *and section 318(a)(3)* shall not apply if * * *." The Supreme Court has held, "There is a basic difference between filling a gap left by Congress' silence and rewriting rules that Congress has affirmatively and specifically enacted. * * * Perhaps the wisdom we possess today would enable us to do a better job * * * than Congress did [years ago] * * * but even if that be true, we have no authority to substitute our views for those expressed by Congress in a duly enacted statute." *Mobil Oil Corp. v. Higginbotham, Administratrix*, 436 U.S. 618, 625-626 (1978). Where Congress has specifically excluded a term or phrase, it is not for the courts to read that term or phrase into the statute. *United States v. Moreno*, 561 F.2d 1321, 1322 (9th Cir. 1977). Such a rewriting of a statute, plain on its face, is an example of lawmaking as distinguished from statutory interpretation that is beyond the power of the courts. *Gaddis v. Calgon Corp.*, 449 F.2d 1318, 1319 (5th Cir. 1971). Accord, *Allen v. David*, 334 F.2d 592, 601 (5th Cir. 1964), cert. denied 379 U.S. 967 (1965).

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[24]For a general analysis of the *Rickey* opinion, see A. Andrews, "Estate Waiver of the Estate-Beneficiary Attribution Rule in Nonliquidating Redemptions Under Section 302 and Related Matters: The *Rickey* Case in the Fifth Circuit," 35 Tax L. Rev. 147 (1979); Comment, "Stock Redemptions and the Estate-Attribution Rules," 128 U. Pa. L. Rev. 650 (1980); C. Fassler, "Waiver of Entity Attribution — The *Rickey, Jr.* Case," 57 Taxes 658 (1979).

Treating the redemption in the *Rickey* case as a distribution under section 301, rather than an exchange under section 302(a), may have seemed to the Fifth Circuit so inappropriately harsh as to violate basic principles of fairness. However, so long as the results do not violate the constitutional protections of due process and equal protection, "Whether a transaction or result is taxable and what the tax is is not a matter to be determined in law upon considerations of general justice or equity. It is a matter of statutes and valid regulations, and what they mean." *Jeffries v. Commissioner*, 158 F.2d 225, 226 (5th Cir. 1946), cert. denied 330 U.S. 843 (1947).

The Fifth Circuit's third ground is stated as follows:

> It cannot be argued that the estate's motivation in allowing this redemption was one of benefitting the beneficiaries. Rather the estate was merely carrying out the provisions of decedent's will — selling the shares back to the Corporation and distributing the proceeds to the beneficiaries, thereby terminating its control over the corporation. We will not find that decedent's death was a device to bleed out corporate profits at capital gains rates. [592 F.2d at 1258.]

Again, we respectfully disagree that the estate's motivation is relevant to the section 302 question. As the Supreme Court stated in *Davis:*

> It was clearly proper for Congress to treat distributions generally as taxable dividends when made out of earnings and profits and then to prevent avoidance of that result without regard to motivation where the distribution is in exchange for redeemed stock.
>
> We conclude that that is what Congress did when enacting § 302(b)(1) * * * [397 U.S. at 313.]

We think the irrelevance is equally applicable to section 302(b)(3).

The trust urges that the holding in the *Rickey* case should control our decision under the doctrine of *Golsen v. Com-*

missioner, 54 T.C. 742 (1970), affd. 445 F.2d 985 (10th Cir.), cert. denied 404 U.S. 940 (1971). In *Golsen* we said that "better judicial administration requires us to follow a Court of Appeals decision which is squarely in point where appeal from our decision lies to that Court of Appeals and to that court alone." (54 T.C. at 757.)

Respondent argues that the *Golsen* rule applies only where the Court of Appeals has decided a case that is "squarely in point," citing *Cottrell v. Commissioner*, 72 T.C. 489, 492–493 (1979), and *Lerner v. Commissioner*, 71 T.C. 290, 297 (1978), as examples in which this Court did not apply the rule where the cases were distinguishable from the appellate precedents in the circuits to which an appeal would lie. He contends that *Rickey* can be distinguished on the basis of the redemption option in the articles of incorporation and the corresponding direction in the decedent's will. The trust in the present case has no such similar provision requiring it to offer the shares to MDI prior to any alternative disposition, nor do we have any evidence that the articles of incorporation of MDI required redemption.[25]

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[25]Respondent suggests on brief that the trust (not being required to offer the shares to MDI, itself) and the beneficiaries could have achieved favorable tax treatment by dissolving the David Metzger Trust, making in-kind distributions of the MDI stock to the respective beneficiaries and then have MDI redeem Catherine's, Cecelia's and Nora's stock. (As it later turned out, Cecelia disclaimed her interest in the David Metzger Trust on Aug. 10, 1976, and Catherine did the same on Oct. 12, 1976.) The individuals could then have followed the procedures of sec. 302(c)(2) so that Nora's stock would not be attributed to her daughters, Catherine and Cecelia, or vice versa, thus permitting Nora, Catherine, and Cecelia to qualify for capital gains treatment under sec. 302(b)(3). See Rev. Rul. 79-67, 1979-1 C.B. 128. On brief, the trust agreed with this suggestion but contended that because the beneficiaries did not obtain proper advice as to the potentially differing tax consequences of the alternative courses of action, they fell into a "trap for the unwary." Regarding the actual facts of the present case, however, "Taxation deals not with what was attempted to be done but with what was done." *Jeffries v. Commissioner*, 158 F.2d 225, 226 (5th Cir. 1946), cert. denied 330 U.S. 843 (1947).

We agree with respondent. The important distinguishing factor between the facts before the Fifth Circuit in *Rickey* and those in the present case is that the redemption in *Rickey* was required by the decedent's will [26] and the articles of incorporation of the redeeming corporation.

The Fifth Circuit pointed out that the estate's motivation in proceeding with the redemption was not to benefit the beneficiaries, but to carry out the provisions of the decedent's will. By contrast, the redemption in the present case was effectuated solely to accomplish the objectives of the beneficiaries, which were to split up the separate family businesses so that there would not be any further family discord during board of directors and stockholders meetings over the proper operation of the businesses.

In *Rickey*, the Court relied on the fact that the corporate policy of purchasing a deceased shareholder's interest in the corporation through redemption was designed to insure that control of the company was maintained in the hands of those who were active in the business. In the present case, the David Metzger Trust had been a passive stockholder for at least 20 years, from David Metzger's death in 1953 until the redemption in 1973.

For these reasons, we think the *Rickey* case is not "squarely in point" concerning the present case, and thus, the *Golsen* rule need not be applied. Accordingly, we hold that the agreement filed by the trust was ineffective to waive the attribution rules of section 318(a)(3). *Johnson Trust v. Commissioner*, 71 T.C. 941 (1979).

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[26] It would appear that a minor amount of pre-death planning would enable all estates under the *Rickey* rule to avoid the attribution rules. One commentator has suggested the waiver of entity sanctioned by *Rickey* may even apply to redemptions required in employment agreements and buy-sell agreements. C. Fassler, "Waiver of Entity Attribution—The *Rickey Jr.* Case," 57 Taxes 658, 662 (1979).

Issue 3

The final issue is whether MDI may properly deduct for the fiscal years ended September 30, 1973, September 30, 1974, and September 30, 1975, despite section 267, accrued interest paid to Cecelia, a cash method taxpayer, more than 2½ months after the close of MDI's fiscal years.

MDI redeemed Cecelia's stock with a promissory note dated January 22, 1973, in the original principal amount of $627,110.53. The terms of the note provided for payment in three equal annual installments, together with interest, beginning January 22, 1974. MDI performed in accordance to the terms of the note, making payments in January 1974, 1975, and 1976. MDI, an accrual method taxpayer, claimed deductions for accrued interest expense, with respect to the note, for its taxable years ended September 30, 1973, 1974, and 1975. Because such interest was not actually paid within 2½ months after the end of the taxable years in question, and, because Cecelia was a cash method taxpayer, respondent determined that the deductions claimed by MDI for the taxable years in issue should be disallowed pursuant to section 267(a)(2). Since Cecelia owned no MDI stock after the redemption, respondent's contention is premised on the attribution to Cecelia, under section 267(c), of the MDI stock owned by her brother, Jacob.

MDI, however, asserts that family discord is a relevant factor to be considered in the application of the family attribution rules of section 267(c). It contends that the section 267(c) attribution rules should be ignored in situations where the discord is so severe as to establish that the pertinent family members would not act in concert or for the benefit of each other.

Section 163(a) allows a deduction for interest which is either paid or accrued during the taxable year on indebtedness owed by the taxpayer. Thus, the proper accrual of interest expense on indebtedness of the taxpayer will result in the allowance of a deduction under section 163, notwithstanding the absence of an actual payment of such interest

during the taxable year. However, certain exceptions to the general rule of section 163 have been enacted to prevent the use of this provision as a tax avoidance device. One such exception is set forth in section 267, which provides, in pertinent part, as follows:

> (a) DEDUCTIONS DISALLOWED. — No deduction shall be allowed —
>
> * * * * * * *
>
> (2) UNPAID EXPENSES AND INTEREST. — In respect of expenses, otherwise deductible under section 162 or 212, or of interest, otherwise deductible under section 163,—
>
> (A) If within the period consisting of the taxable year of the taxpayer and 2½ months after the close thereof (i) such expenses or interest are not paid, and (ii) the amount thereof is not includible in the gross income of the person to whom the payment is to be made; and
>
> (B) If, by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not, unless paid, includible in the gross income of such person for the taxable year in which or with which the taxable year of the taxpayer ends; and
>
> (C) If, at the close of the taxable year of the taxpayer or at any time within 2½ months thereafter, both the taxpayer and the person to whom the payment is to be made are persons specified within any one of the paragraphs of subsection (b).

The congressional purpose underlying the enactment of the predecessor of section 267 was to prevent the use of the differing methods of reporting income for Federal income tax purposes in order to obtain artificial deductions for interest and business expenses. It was recognized that there were instances where an individual on the accrual method

became indebted to a creditor with whom he enjoyed a special relationship, such as a member of his family, or to a corporation he controlled, and his creditor reported income on the cash method. Thereafter, as interest became due on the debt, the debtor on the accrual method reported the interest as a deduction for income tax purposes, but he did not make any actual payment to his creditor. Since the creditor was on the cash method, he reported no income. The debtor would consequently gain the benefit of a current deduction, whereas the related creditor would defer income recognition until the year of receipt of actual payment. Sometimes the sum involved would escape income taxation altogether because the payment was timed to a year when the creditor had offsetting losses.[27]

As provided in section 267(a)(2)(C), the limitations on the deductibility of interest and other expenses imposed by section 267(a) are applicable only in situations involving a taxpayer and another person or entity having a specified relationship, set forth in section 267(b)(2), as "an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual." For purposes of determining the existence of such relationship, section 267(c) sets forth the following rules of constructive ownership of stock:

> (c) CONSTRUCTIVE OWNERSHIP OF STOCK. — For purposes of determining, in applying subsection (b), the ownership of stock —
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> * * * * * * *
>
> (2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;
>
> * * * * * * *

[27] H. Rept. 1546, 75th Cong., 1st Sess. (1937), 1939-1 C.B. (Part 2) 704, 724-725. See also *Young Door Co. v. Commissioner*, 40 T.C. 890, 893 (1963); *Geiger & Peters, Inc. v. Commissioner*, 27 T.C. 911, 917 (1957); *Platt Trailer Co. v. Commissioner*, 23 T.C. 1065, 1068 (1955).

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendents; * * *

Since the Supreme Court's decision in *McWilliams v. Commissioner*, 331 U.S. 694 (1947), courts have adopted a literal approach with regard to section 267, whereby a deduction encompassed within the scope of the statute has been disallowed without consideration of other mitigating circumstances. Section 267 and its predecessor, section 24(b), I.R.C. 1939, prohibited not only unpaid expenses and interest but also losses from sales or exchanges between certain related parties. The *McWilliams* case concerned the latter provision and held that section 24(b), I.R.C. 1939, provided an absolute prohibition against the allowance of losses on any sales between members of certain designated groups.

MDI maintains that the cases in which *McWilliams* has been cited or followed have focused principally on the strict application of section 267(a) to the specific interest or expense deduction in question and never on the relationship between the attribution rules of section 267(c) and the operative provisions of section 267(a) and (b). In view of the similarity of section 267(c) to section 318,[28] MDI contends that, where hatred and disharmony exist between the related parties, the initial focus in applying section 267 should be on whether to apply the attribution rules at all. Petitioners contend that not only were the attribution rules of sections 267 and 318 intended to be similarly applied, but also that section 267 was not enacted by Congress in order to prevent the avoidance of Federal income taxes in situations involving extreme discord and hatred between siblings. MDI does not argue that mere lack of a tax-

[28]For a general discussion of the attribution rules in secs. 267, 318, and 544, see F. Ringel, S. Surrey & W. Warren, "Attribution of Stock Ownership in the Internal Revenue Code," 72 Harv. L. Rev. 209 (1958); B. Randall & K. Benson, "Family Dissension and the Attribution Rules of Sections 267, 318, and 544" 53 Taxes 534 (1975).

avoidance motive in executing the promissory note to Cecelia and in paying the principal and interest more than 2½ months after the end of its fiscal year should preclude the disallowance of the interest deduction. Rather, it contends that the extreme discord and hatred existing between Jacob and Cecelia prevented such parties from enjoying the requisite "special relationship"[29] intended by Congress as a condition precedent to the application of the disallowance provisions of section 267(a). In other words, it argues that the family discord nullified the attribution of stock ownership from Jacob to Cecelia and thus Cecelia lacked the relationship with MDI required by sections 267(a)(2)(c) and 267(b) as a predicate to the disallowance provisions of section 267(a).

We disagree. When the Supreme Court was interpreting section 24(b) of the 1939 Code, then in effect, in *McWilliams*, that section included both the operational sections now found in section 267(a)(1) and (b) *and* the attribution sections now found in section 267(c).[30]

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[29]H. Rept. 1546, 75th Cong., 1st Sess. (1937), 1939-1 C.B. (Part 2) 704, 724-725.

[30]SEC. 24. ITEMS NOT DEDUCTIBLE.

(b) Losses From Sales or Exchanges of Property. —

(1) Losses disallowed.—In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly—

(A) *Between members of a family, as defined in paragraph (2)(D);*

(B) Except in the case of distributions in liquidation, between an individual and a corporation more than 50 per centum in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(C) Except in the case of distributions in liquidation, between two corporations more than 50 per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

In the *McWilliams* case, the taxpayer managed the independent estate of his wife and on a number of occasions ordered his broker to sell certain stock for the account of one of the two, and to buy the same number of shares of the same stock for the other, at as nearly the same price as possible. On each occasion, the sale and purchase were negotiated through a stock exchange, and the identity of the persons buying from the selling spouse and the persons selling to the buying spouse was never known. The taxpayers contended that Congress never intended to disallow

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(D) Between a grantor and a fiduciary of any trust;

(E) Between the fiduciary of a trust and the fiduciary of another trust, if the same person is a grantor with respect to each trust; or

(F) Between a fiduciary of a trust and a beneficiary of such trust.

(2) Stock ownership, family, and partnership rule. — *For the purposes of determining, in applying paragraph (1), the ownership of stock* —

(A) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(B) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(C) An individual owning (otherwise than by the application of subparagraph (B)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(D) *The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;* and

(E) Constructive Ownership as Actual Ownership. — Stock constructively owned by a person by reason of the application of subparagraph (A) shall, for the purpose of applying subparagraph (A), (B), or (C), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of subparagraph (B) or (C) shall not be treated as owned by him for the purpose of again applying either of such subparagraphs in order to make another the constructive owner of such stock.

[Emphasis added.]

losses on such transactions which, having been made through a public market, were undoubtedly bona fide sales, and that disallowance of such losses would be tantamount to treating a husband and wife as a single individual for tax purposes.

The Supreme Court answered this objection to the attribution rules by saying:

> We are not persuaded that Congress had so limited an appreciation of this type of tax avoidance problem. Even assuming that the problem was thought to arise solely out of the taxpayer's inherent advantage in a contest concerning the good or bad faith of an intra-family sale, deception could obviously be practiced by a buying spouse's agreement or tacit readiness to hold the property sold at the disposal of a selling spouse, rather more easily than by a pretense of a sale where none actually occurred, or by an unfair price. The difficulty of determining the finality of an intra-family transfer was one with which the courts wrestled under the pre-1934 law, and which Congress undoubtedly meant to overcome by enacting the provisions of § 24(b). [331 U.S. at 698. Fn. ref. omitted.]

The Court specifically discussed the attributions rules and their strict application:

> Section 24(b) states an absolute prohibition — not a presumption — against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic interests. It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions. [331 U.S. at 699. Fn. ref. omitted.]

Thus, the Supreme Court realized that some legally genuine intra-group transfers which resulted in economically genuine

realizations of loss would be caught in this absolute prohibition. Because such intra-group transfers did not "usually" result in genuine economic realizations of loss, it held that Congress did not deem any of them deductible. *W. A. Drake, Inc. v. Commissioner*, 3 T.C. 33, 39 (1944), affd. 145 F.2d 365 (10th Cir. 1944).

In our opinion, the attribution rules should not be applied differently to the unpaid expenses and interest than as applied to losses from sales even where there is evidence of family discord. In *Radom & Neidorff, Inc. v. United States*, 150 Ct. Cl. 826, 281 F.2d 461 (1960), cert. denied 365 U.S. 815 (1961), a brother and sister each owned 50 percent of the outstanding stock of the taxpayer corporation. As a result of personal controversy, the sister refused to countersign the brother's payroll checks, and thus his salary was not paid within 2½ months after the close of the corporation's taxable year. The Court of Claims found that no actual or constructive payment had been received by the brother within the prescribed period, and thus held that section 267(a) was applicable irrespective of the absence of a tax avoidance motive.

Section 267, as interpreted by the Supreme Court in *McWilliams*, states an absolute prohibition. There is no mitigation of its attribution rules. *Miller v. Commissioner*, 75 T.C. 182 (1980). It is true that a hardship may result in particular cases. Congress could have provided some exception for certain intra-family transactions. But it did not do so. It may be that such a qualification would have defeated the purpose of the measure, or it may be that consideration of administrative convenience in collecting revenue outweighed the occasional hardship which would result in particular cases. But, whatever the reason, we cannot, without indulging in judicial legislation, grant an exception to the broad provisions adopted by Congress. *Blum v. Commissioner*, 5 T.C. 702 (1945); *Miller v. Commissioner, supra.*

To reflect the concessions of the parties and our conclusions with respect to the disputed issues,

Decisions will be entered in all dockets under Rule 155.

Reviewed by the Court.
CHABOT, J., concurs.

TANNENWALD, *J.*, concurring: While I agree that the stock owned by the beneficiary of the petitioner trust must be attributed to it, I reach this conclusion by a path other than that taken by the majority. I therefore concur in the Court's opinion only as to Issues 2 and 3.

As a result of a bitter family feud, the MDI stock held by the Metzger Trust (the trust) was completely redeemed. There is no question that this redemption would be "not essentially equivalent to a dividend" within the meaning of section 302(b)(1) were it not for the attribution rules of section 318. Those rules cause the trust to be the owner — albeit only constructively — of 100 percent of the MDI stock outstanding after the redemption and accordingly repel the trust from the gates of section 302(b)(1). The trust argues that the presence of the family feud should protect it from the clutches of section 318 and allow it access via section 302(b)(1) to the basis recovery and capital gains treatment of section 301(c)(2) and (3).

Whether a corporate distribution is essentially equivalent to a dividend is a question of fact, although which factors may contribute to a court's finding is, of course, a question of law.[1] In *United States v. Davis*, 397 U.S. 301 (1970), the Supreme Court held that the corporate purpose behind a redemption should play no role in determining dividend equivalency under section 302(b(1). To the extent, then, that the trust herein argues that the family feud demon-

[1]Sec. 1.302-2(b), Income Tax Regs.; *Wright v. United States*, 482 F.2d 600, 606 (8th Cir. 1973).

strates the bona fide business purpose of the corporate distribution, its argument is irrelevant under *Davis*.

The trust, however, seeks to benefit from the family disharmony in a different way. The attribution rules of section 318 provide that one individual or entity should be treated as the owner of stock in fact owned by another individual or entity because of the close relationship between the two. For example, parent/child, husband/wife, and trust/beneficiary relationships trigger constructive ownership by virtue of section 318. The underlying premise of these attribution rules is that, because of a sharing of interest and advantage, a nominal redemption might have the effect, not of a sale of shares to the corporation, but of a corporate dividend, and that the release of shares by the "redeemed" taxpayer might possess little substance because of shares retained by a related taxpayer. S. Rept. 1240, 88th Cong., 2d Sess. 7 (1964), 1964—2 C.B. 701, 705—706. The trust simply argues that family discord undermines the premises of the attribution rules and that they should not be applied when they belie reality.[2]

The Supreme Court held in *Davis* that the attribution rules of section 318 should be applied by a court when making a section 302(b)(1) determination, but it did not decide whether family discord may soften their application because that issue was not presented; the attribution in that case was between two happily married spouses and their children. The respondent would have us hold, however, that the broad language used in the *Davis* opinion should be read to foreclose *any mitigation* of the application of the attribution rules; admittedly, there is judicial support for this position.[3]

In *Robin Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir. 1975), the First Circuit held that *Davis* did not preclude

[2]See *Title Insurance & Trust Co. v. United States*, 484 F.2d 462, 465 n. 4 (9th Cir. 1973).

[3]*Robin Haft Trust v. Commissioner*, 61 T.C. 398 (1973), and 62 T.C. 145 (1974) (supplemental opinion), revd. and remanded 510 F.2d 43 (1st Cir. 1975). Cf. *Niedermeyer v. Commissioner*, 62 T.C. 280, 286 (1974), affd. per curiam 535 F.2d 500 (9th Cir. 1976).

the use of a family feud. In that case, as in the case at bar, the taxpayer/trust undoubtedly would have been entitled to the protection of section 302(b)(1) but for the section 318 attribution. However, the taxpayer in *Robin Haft Trust* could only be treated as a constructive owner of the redeeming corporation's stock if ownership could be attributed under section 318(a)(1)(A)(ii) from a father to his child, and the taxpayer there argued that the parent/child relationship was so strained that attribution was unreasonable. Accepting that the existence of family disharmony can outweigh the attribution rules, the Court of Appeals remanded for additional fact-finding as to the breakdown of the father/child relationship. See J. Boyd & M. Boyd, "Family discord may negate attribution rules and allow capital gain treatment of a redemption," 15 Taxation for Accountants 362, 364-365 (1975).

The respondent herein argues, despite the clear implication to the contrary of the language of section 1.302-2(b), Income Tax Regs.,[4] that *Robin Haft Trust* is inconsistent with *United States v. Davis, supra,* or that if it is not, it is nonetheless ill advised and should not be followed. Although the majority of this Court feels compelled to respond to these challenges, I would decline the opportunity to take so precipitous a step until required to do so, and the facts of

[4]Sec. 1.302—2(b), Income Tax Regs., states—

"The question of whether a distribution in redemption of the stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case. *One of the facts* to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a). [Emphasis added.]"

The Supreme Court in *United States v. Davis,* 397 U.S. 301 (1970), ignored this regulation except for a general reference to the regulation according with the view that section 318 "applies to all of section 302" — a reference which does not answer the question we have before us, namely, *the extent to which it applies.* See Comment, 55 B.U. L. Rev. 667, 674 (1975); Comment, 28 Maine L. Rev. 222, 237-239 (1976). In this connection, we note that, at one point in its opinion, the Supreme Court merely states that "Congress intended that they [the attribution rules] *be taken into account* wherever ownership of stock was relevant." See 397 U.S. at 307; emphasis added.

this case make no such demand. Indeed, respondent on brief makes clear that the instant case can be disposed of on a narrower ground.

The trust herein is the constructive owner of 100 percent of the shares because its beneficiary, one Jacob Metzger (Jacob), is deemed to own them all. See sec. 318(a)(3)-(B)(i). He is the actual owner of some, and is the constructive owner of the rest of the shares, which are actually owned by a trust, of which he is the beneficiary, and trusts for each of his children. See sec. 318(a)(2)(B)(i) and (a)(1)(A)(ii). There is no link in the chain from child's trust to child to father (Jacob) to the trust where disharmony exists; to the contrary, the only fight was between Jacob and his sisters, and no one is seeking to attribute stock ownership across those unfriendly lines.[5] To be sure, were the trust controlled by a trustee who was given substantial discretion and who thought ill of Jacob, this case might be fitted within the *Robin Haft Trust* mold. But here, Jacob was both the trustee of the taxpayer/trust and a beneficiary, and it seems obvious that Jacob could not be hostile to himself. Thus, all of the attribution rules relevant to the instant case accord with reality, and so their application herein is consistent with the rationale behind section 318. We need not decide whether we may or should ameliorate the application of the section 318 rules if justice would be served thereby, and I believe that a proper respect for the judicial function and its inherent limitations requires that we do not decide these questions before they are properly presented.

The majority apparently does not entirely reject the use of family discord. However, it limits such use to cases in which the taxpayer's actual and constructive ownership after the redemption is less than his actual and constructive ownership before the redemption, and only at that point is it used to determine whether such reduction was "meaning-

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[5]Somewhat ironically, attribution between siblings is not even authorized by the statute. See sec. 318(a)(1) and (a)(5)(B). Compare secs. 267(c)(4), 544(a)(2), and 554 (a)(2).

ful." Yet, if a taxpayer's only ownership of stock after the redemption is purely constructive, and if the premise upon which that legal fiction was built is refuted by family discord, of what possible relevance can the *amount* of ownership fictionally attributed be? The Court today raises to the level of an essential prerequisite to rational factfinding a factor which, under the circumstances of this case, seems wholly irrelevant, and thereby paves a road for objectionably arbitrary results.

Suppose a father and son jointly own a corporation until they have a bitter dispute, at which time the son is completely redeemed. If, before the redemption, they owned in the aggregate 100 percent of the corporation's outstanding stock, they each will be deemed to own 100 percent of the corporation after the redemption. Thus, the rule which the majority feels compelled to adopt would treat the redemption as essentially equivalent to a dividend under section 302(b)(1).[6] However, if a third party (say, an employee) owned as little as 1 share, the redemption would reduce percentage-wise the son's constructive ownership ever so slightly below that of his previous actual and constructive ownership, and thus he would now be free under the majority's rule to argue that the attribution rules should be overlooked because of the family feud.[7] Yet, it seems clear to me that whether or not a third party owns a minimal amount of stock has nothing whatsoever to do with the issue. How one should dovetail *United States v. Davis*, *supra*, with the views of the Court of Appeals in *Robin Haft Trust v. Commissioner*, *supra*, can be left for another day.[8] I would refrain from doing more than deciding this case solely upon the basis that the family hostility in this case does not preclude the application of section 318.

FAY, IRWIN, STERRETT, and HALL, *JJ.*, agree with this concurring opinion.

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[6] In order to keep the hypothetical simple, I have ignored the waiver provisions of sec. 302(c)(2) which might be available to the son as I have posed the case. However, by simply modifying the facts in *Robin Haft Trust*, one can create a perfectly valid if somewhat complex situation involving a trust which would be analogous to the situation presented above.

[7] Cf. *Parker v. Commissioner*, T.C. Memo. 1961-176.

[8] See, e.g., A. Cathcart, "Section 302 Redemptions: Family Fights and Attribution," 61 A.B.A.J. 1272 (1975).

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 81-4324

Your Nos. TC 8824-77, 8856-77 & 6990-79

DAVID METZGER TRUST, JACOB METZGER, TRUSTEE, and METZGER DAIRIES, INC.,
Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the Decision of the United States Tax Court
Before THORNBERRY, JOHNSON and HIGGINBOTHAM, Circuit Judges.

JUDGMENT

This cause came on to be heard on the transcript of the record of the Tax Court of the United States, and was argued by counsel;

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the decisions of the said Tax Court in the cause be, and the same are hereby affirmed;

IT IS FURTHER ORDERED that petitioners-appellants pay to respondent-appellee the costs on appeal to be taxed by the Clerk of this Court.

DECEMBER 13, 1982

ISSUED AS MANDATE:

David METZGER TRUST, et al.,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 81-4324.

United States Court of Appeals,
Fifth Circuit.

December 13, 1982.

Taxpayers petitioned for a redetermination of deficiencies. The Tax Court, 76 T.C. 42, upheld the deficiencies, and taxpayers appealed. The Court of Appeals, Patrick E. Higginbotham, Circuit Judge, held that: (1) the attribution rules of the Internal Revenue Code were applicable despite family discord, and (2) a trust could not waive the attribution rules by filing a waiver agreement.

Affirmed.

1. Internal Revenue — 3815

Family hostility did not mitigate application of attribution rules in determining dividend equivalency of redemption of stock. 26 U.S.C.A. § 302(b)(1).

2. Internal Revenue — 3815

Trust could not waive attribution rules by filing waiver agreement. 26 U.S.C.A. §§ 302(c)(2)(A)(iii), 318(a).

3. Internal Revenue — 3815

Attribution rules of statute disallowing deductions for certain transactions between related taxpayers were applicable to interest payments between family members, even though family members were in discord. 26 U.S.C.A. § 267(c).

Appeal from the Decision of the United States Tax Court.

Before THORNBERRY, JOHNSON and HIGGINBOTHAM, Circuit Judges.

PATRICK E. HIGGINBOTHAM, Circuit Judge:

We decide today a story driven by tensions as old as Genesis but told in the modern lexicon of the tax law. It is the story of David who built a business and left it in the charge of his eldest son Jacob to be shared with Jacob's two sisters Catherine and Cecelia, of their alienation and resulting quarrel with the tax collectors. In reviewing this decision of the Tax Court we are asked to determine the tax consequences of a reallocation of ownership of this family-owned business operated as a closely held corporation. In doing so we face three questions: (1) whether the attribution rules of I.R.C. § 318(a) must be applied despite family discord in determining whether a redemption meets the "not essentially equivalent to a dividend test" of § 302(b)(1); (2) whether a trust may waive the attribution rules of § 318(a) by filing a waiver agreement pursuant to § 302(c)(2)(A)(iii); (3) whether the attribution rules of § 267(c) must be applied to interest payments between family members in discord. Governed by the plain language of the Code, a goal of a coherent tax policy, and the relevant Supreme Court precedents, 76 Tax Court 42, we affirm the decision of the Tax Court.

FACTS

The relevant facts are not in dispute and have been agreed to in a stipulation of record. Appellant David Metzger Trust was created by David Metzger in 1942 to benefit his wife as life income beneficiary and his three children, Jacob, Catherine, and Cecelia, as one-third remaindermen each. Jacob, the eldest son, was named trustee of the Trust. Four years later, David incorporated the family business as Metzger Dairies, Inc., the other appellant. The Trust became a shareholder of Metzger Dairies.

On David's death in 1953 Jacob Metzger assumed control of Metzger Dairies. Catherine and Cecelia were directors. In the years following the father's death the sibling quarrel

grew in intensity. By the 1960's, open animosity developed among Jacob, Catherine, and Cecelia. Whatever the source of their alienation, a downturn in the success of the dairy only exacerbated the problem. Catherine and Cecelia became angry when the corporation stopped paying dividends. Catherine resented what she considered to be Jacob's interference in the management of Metzger Dairy of San Antonio, a corporation of which her son was president but whose stock was owned for the most part by the same parties who owned the stock of Metzger Dairies. Cecelia was annoyed at both Jacob and Catherine because both corporations failed to pay dividends. The argument among Jacob, Catherine, and Cecelia over these and other issues unrelated to the business of the corporations continued until 1972, when the acrimony reached the point that Jacob, Catherine, and Cecelia concluded it was necessary to terminate their joint ownership of the corporations.

After lengthy negotiations all agreed that Jacob and his family would own Metzger Dairies, Catherine and her family would own Metzger Dairy of San Antonio, and Cecelia and her family would be cashed out. The plan was for Metzger Dairies to redeem all shares owned by Catherine, Cecelia, the trusts for Catherine and Cecelia, and the David Metzger Trust. It was necessary to include the David Metzger Trust in the redemption because Catherine and Cecelia were due to receive one-third of the Trust corpus on the death of David Metzger's widow.

Immediately before the redemption, the stock of Metzger Dairies was held as follows:

Stockholder	Shares
David Metzger Trust	420
Nora Metzger (David Metzger's widow)	420
Jacob Metzger	600
Trust for Jacob Metzger	120
Catherine	600
Trust for Catherine	120
Cecelia	600
Trust for Cecelia	120

The redemption occurred on January 22, 1973, leaving Metzger Dairies' stock as follows:

Stockholder	Shares
Jacob Metzger	600
Trust for Jacob Metzger	120
Trust for David Metzger, II (son of Jacob)	294
Trusts for Nan Metzger (daughter of Jacob)	207

The Commissioner concedes that the principal motivation for the redemption was not to receive undistributed earnings,[1] but to end a business relationship that was characterized by hatred and discord among Jacob, Catherine, and Cecelia. On February 10, 1976, Jacob, as trustee of the David Metzger Trust, delivered to the IRS a waiver agreement, executed pursuant to 26 C.F.R. § 1.302–4 and purporting to waive any future interest the trust might have in the corporation.

The deferred obligation of Metzger Dairies to pay for Cecelia's 600 shares was evidenced by a promissory note executed by the corporation and payable to Cecelia in three annual installments of principal, plus interest, beginning January 22, 1974. Interest payments were actually made on January 21, 1974, January 7, 1975, and January 5, 1976. As a cash basis taxpayer, Cecelia reported interest income in 1974, 1975 and 1976, the respective years of receipt. Metzger Dairies was an accrual basis taxpayer and claimed deductions in the fiscal years ending September 30, 1973, September 30, 1974, and September 30, 1975, for the liability for interest as it accrued.

In May 1977 the Commissioner of Internal Revenue assessed deficiencies against the David Metzger Trust for the calendar year 1973 and against Metzger Dairies for the fiscal years ending September 30, 1973, and September 30,

[1]As of the time of redemption, Metzger Dairies had accumulated earnings of $1,815,060.77.

1974.[2] On August 17, 1977, Metzger Dairies and the Trust petitioned the Tax Court for a redetermination of these deficiencies. Later the Commissioner assessed deficiencies against Metzger Dairies for fiscal year 1975 as well.[3] Metzger Dairies filed a second petition for redetermination with the Tax Court. All of the cases were consolidated for trial. The Tax Court upheld the deficiencies. After an agreed computation had been filed, it entered the judgment[4] here appealed from.

THE TRUST'S APPEAL

(a) *The Statutory Framework*

While ordinary income treatment for dividends and capital gains treatment for sales of stock are primer categories of the Internal Revenue Code, their line of separation with stock redemptions is less than bright. Stock redemptions may resemble both sales of stock and dividends, since they involve corporate payment to a shareholder for stock but may also distribute corporate earnings. The desire for tax advantage insures recurring disputes over when a stock redemption is a dividend and when it is a purchase of stock. Given the inherent economic incentives of stock redemptions in myriad form mirroring the variety of their commercial

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[2]The Commissioner assessed a deficiency of $292,977.47 against the Trust on the grounds that the $585,303.25 it received in redemption of the Metzger Dairies stock should have been reported as dividend income. The Commissioner assessed deficiencies against Metzger Dairies of $2,106.86 (FY 1973) and $24,856.38 (FY 1974) mainly after disallowing interest deductions of $32,167.28 (FY 1973) and $31,533.07 (FY 1974) for interest accrued but not paid to Cecelia until more than 2½ months after the close of the fiscal year.

[3]The Commissioner disallowed $13,926.46 of the interest deduction claimed by Metzger Dairies for FY 1975 that represented interest accrued but not actually paid to Cecelia until more than 2½ months after the close of the fiscal year. On this basis a deficiency of $6,684.68 was assessed.

[4]The Tax Court found deficiencies of $187,037.80 on the part of the Trust for taxable year 1973, $21,677.55 on the part of Metzger Dairies for taxable (i.e., fiscal) year 1974, and $6,684.68 on the part of Metzger Dairies for taxable (i.e., fiscal) year 1975.

objectives and often constructed by lawyers trained in an adversarial tradition, a workable decision mechanism must be capable of looking through innovative form to the economic reality beneath. It is not surprising then that the categorization process is heavily indexed by actual changes in corporate ownership. That is, when a redemption significantly reduces a stockholder's voting interest in a corporation, it resembles a sale of stock more than a dividend and is to be accorded capital gains treatment. On the other hand, if the redemption is basically a pro rata distribution, it is treated as a dividend.[5] This principle, whose application may also be termed a wary search for reality, is overlaid by the circumstance that here the tax code presents in an acute fashion the constant judicial tension of the competing demands of predictability and case specific equity. Despite their generality these principles form the regression line for case reconciliation, and as we will see they provide an aid to the identification of the judicial outliers.

Our specific analysis is channelled by the Code's structure: payments to shareholders from accumulated earnings will be treated as dividends unless the payment can be brought under an exception. That is, the controlling premise is that distributions by corporations to stockholders out of the taxable year's earnings or out of accumulated earnings are to be treated as dividends. I.R.C. § 316(a). Section 302 provides the exceptions. If the redemption is "not essentially equivalent to a dividend," § 302(b)(1), a "substantially disproportionate redemption of stock," § 302(b)(2), or a "termination of [the] shareholder's interest," § 302(b)(3),

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[5]So, for example, if Stockholder A owns 60 of a corporation's 100 shares of common stock, Stockholder B owns the other 40 shares, and the corporation redeems 50 of A's shares, capital gains treatment is appropriate. On the other hand, if the corporation redeems only 30 of A's shares and 20 of B's, the redemption is treated as a dividend to the extent there are earnings to distribute. For some practical examples illustrating the effects of §§ 302 and 318, *see Rickey v. United States*, 592 F.2d 1251, 1256 (5th Cir. 1979). *See also* Treas. Reg. § 1.302-2(b). There is a gray area — distributions that do not significantly reduce a stockholder's voting interest but are not pro rata, either.

it will be treated as a distribution in exchange for the stock. At first glance, all three of these provisions are applicable to the Metzger transaction since the corporation purchased all the stock of Catherine, Cecelia, their trusts, and the David Metzger Trust, while at the same time made no payments to the other stockholders, namely Jacob Metzger and his trust. Yet the attribution rules of the Code pose immediate problems.

Attribution

If a father sells some of his shares back to a corporation, yet after the transaction he and his ten year old son end up owning the same combined percentage of voting shares, the transaction cast as a stock purchase might be an extraction of corporate earnings in nondividend form. The Code responds to this risk, with fixed attribution rules. An individual is considered to own the stock owned by his spouse, children, grandchildren, and parents. § 318(a) (1). An estate or trust is considered to own the stock owned by a beneficiary of the estate or trust. § 318(a) (3). A beneficiary is considered to own proportionately the stock owned by the estate or trust of which he is a beneficiary. § 318(a) (2). By these rules the Trust is the owner of the entire stock of Metzger Dairies both before and after the redemption.[6]

The Code provides that, with one exception, these attribution rules "shall apply in determining the ownership of stock for purposes of" § 302. § 302(c) (1). The one exception is that § 318(a) (1), the rules governing attribution of ownership from individuals to individuals, shall not apply in the

[6]Before redemption the Trust was the constructive owner of Nora, Jacob, Catherine, and Cecelia's shares, because they were its beneficiaries. § 318(a)(3)(B). Jacob, Catherine, and Cecelia were the constructive owners of the shares held by their individual trusts. § 318(a)(2)(B). Thus, the Trust constructively owned all of Metzger Dairies' stock.

After redemption the Trust remained constructive owner of all the stock because the shares held by the trusts for Jacob's children were attributable to the children, § 318(a)(2)(B), thence to Jacob, § 318(a)(1)(A), and finally to the Trust, § 318(a)(3)(B).

case of a distribution described in § 302(b)(3), that is, a complete termination of a shareholder's interest, *if:*

1. "immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor" (§ 302(c)(2)(A)(i));
2. "the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years . . ." (§ 302(c)(2)(A)(ii));
3. the distributee files an agreement (a "waiver agreement") as prescribed by Treasury regulations (§ 302(c)(2)(A)(iii)).[7]

In other words, § 302(c)(2)(A) by its terms permits an *individual* to avoid attribution of ownership if he gets out of the corporation and agrees to stay out.

The commands of §§ 302 and 318 are unambiguous. By their literal language, as an "entity" rather than an individual, the David Metzger Trust does not qualify for the sole statutory exception to the attribution rules. The Trust argues however (1) that family discord should "mitigate" against the applicability of the attribution rules, and (2) that the Trust's filing of a waiver agreement and complete termination of its *actual* interest in the corporation (even though the Trust is not an "individual") effectively waived the attribution rules. We turn to the first contention.

(b) *A Family Discord Exception to Attribution?*

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[7]Even if these three conditions are met, the attribution rules will not be waived if the distributee acquired any of the redeemed stock within the past ten years from a person whose stock ownership is otherwise attributable to him and tax avoidance was a primary purpose of the transaction. § 302(c)(2)(B)(i). Nor will they be waived if within the past ten years a person whose stock ownership is otherwise attributable to the distributee acquired stock from the distributee and tax avoidance was a primary purpose of that transaction, unless the stock is included in the redemption. § 302(c)(2)(B)(ii). These are known as the "look back" provisions; § 302(c)(2)(A)(ii) is known as the "look forward" provision.

[1] The Trust argues that family discord may "mitigate" the application of the Attribution rules in determining dividend equivalency, especially given the undisputed fact that the purpose of the redemption was not to distribute corporate earnings. From the stipulated fact that the purpose of redemption was to bring peace to a family quarrel, the Trust launches two attacks upon the attribution rules. First, it argues that because it is undisputed here that the family cannot function as an economic unit, the attribution rules, built as they are upon that premise, are inapplicable. Second, the Trust argues that even if the Trust by virtue of attribution is virtually the sole shareholder before and after, the redemption was nonetheless not essentially equivalent to a dividend. The argument continues that this follows from the undisputed purpose of the redemption. That is, the purpose not being to bail out corporate earnings, the central base for application of nonequivalency has been touched.

As will be seen the first argument fails because it is built upon the erroneous assumption that attribution is treated by the Code as a rebuttable presumption rather than a mandated view of familial relationships. The second argument fails because it denies full sway to the decision of the Supreme Court in *United States v. Davis*, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970). Indeed, *Davis* provides much of the answer to the first argument as well. For this reason we will address the arguments together, separating them only when necessary to context.

Davis

In *Davis* the Court held that the attribution rules of § 318(a) must be applied before determining dividend equivalency. The Court held that regardless of a purpose other than to distribute corporate earnings the after-attribution structure was such that the redemption was in the nature of a dividend. In *Davis*, the taxpayer had purchased the preferred stock of a corporation in 1945 in order to in-

crease the corporation's working capital so that it might qualify for an RFC loan. As originally planned, the loan was fully repaid and the corporation redeemed the taxpayer's preferred stock. By this time, however, the corporation's common stock was held entirely by the taxpayer, his wife, his son, and his daughter. The Commissioner viewed the redemption as essentially equivalent to a dividend because after application of the attribution rules the taxpayer "owned" 100% of the corporation's common stock. Any distribution to him, therefore, was a pro rata distribution to all the corporation's stockholders, or the essential equivalent of a dividend.

The Supreme Court agreed with the Commissioner's analysis. In its first step it held that the attribution rules had to be applied in determining dividend equivalency under § 302(b)(1). "[T]he attribution rules continued to be made specifically applicable to the entire section, and we believe that Congress intended that they be taken into account wherever ownership of stock was relevant." 397 U.S. at 306–307, 90 S.Ct. at 1044–1045. The taxpayer was deemed the owner of all 1000 shares of the company's common stock.

Second, the Court held that the presence or absence of a tax-avoidance motive could not be considered in determining dividend equivalency under § 302(b)(1). *Id.* 397 U.S. at 311, 90 S.Ct. at 1047. " '[T]he business purpose of a transaction is irrelevant in determining dividend equivalence.' " *Id.* 397 U.S. at 312, 90 S.Ct. at 1047 (quoting *Hasbrook v. United States*, 343 F.2d 811, 814 (2d Cir.1965)). The Court therefore concluded that the IRS had properly characterized the redemption of the preferred stock as essentially equivalent to a dividend, regardless of the taxpayer's (and the corporation's) business purpose back in 1945.[8]

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[8]It is not totally clear that the attribution rules *had* to be applied in *Davis* to reach the Commissioner's result. Even if the taxpayer were not considered the owner of all the corporation's common stock, redemption of his preferred did not reduce his voting interest in the corporation.

In *Davis* the Court reasoned:

> After the application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation. We conclude that such a redemption is always 'essentially equivalent to a dividend' within the meaning of that phrase in § 302(b) (1) . . .

Id. 397 U.S. at 307, 90 S.Ct. at 1045. *Davis* teaches that in applying the "essentially equivalent to a dividend" test after the attribution rules are applied, if the resulting structure has virtually the same incidents of ownership the corporate payments distribute earnings despite an indisputable contrary business purpose.

Treas.Reg. § 1.302–2(b)

Confronted by the Supreme Court's holding in *Davis*, the Trust argues that its position nevertheless is supported by Treas.Reg. § 1.302-2(b), language in *Davis* interpreting § 302(b) (1) as applying whenever there is a "meaningful reduction in the shareholder's proportionate interest," and the legislative history of § 302(b) (1).

Treas.Reg. § 1.302–2(b) provides:

> The question of whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b) (1) depends upon the facts and circumstances of each case. One of the facts to be considered in making this determination is the constructive stock ownership of such shareholder under section 318(a).

Pointing to this language the Trust argues that before and after structure is only one factor in the dividend equivalency inquiry. The argument continues that despite the circumstance that after attribution there was no shift in the incidents of control there was no dividend because indisputably the redemption was for another purpose.

Treas.Reg. § 1.302–2(b), however, contained the same language prior to the *Davis* decision. The regulation is ambiguous. It can be interpreted as the Trust would have it, namely that attribution is only a presumption. On the other hand, it can be interpreted as saying that attribution rules must be given full effect, but are not necessarily decisive on the ultimate issue of dividend equivalency.

"Meaningful Reduction"

It is true, as the Trust points out, that some commentators and courts have indicated that *Davis* does not foreclose arguments for capital gains treatment based on family discord.[9] Professors Bittker and Eustice have said, "The *Davis* decision . . . weakens, but does not eliminate, the 'family fight' argument in mitigation of § 318 attribution under §302(b)(1) . . ." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 9.24 n. 73 (4th ed. 1979). In *Robin Haft Trust v. Commissioner*, 510 F.2d 43 (1st Cir.1975), the First Circuit held that family discord might "negate the presumption" of the attribution rules that the taxpayer trusts exercised continuing control over the corporation after their actual holdings had been redeemed. *Id.* at 48. The trusts had been set up to benefit four children and were funded by shares of the corporation. The father of the children also owned a large percentage of the corporation's stock. While the father was going through divorce proceedings and was not even in contact with the children, the trusts' shares were redeemed as part

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[9] *See, e.g.*, O'Dell & Boyd, "Family Hostility and Stock Redemptions: Revenue Ruling 80-26 Revives the Controversy," 59 Taxes 153, 156-160 (1981) (criticizing a revenue ruling that requires strict application of the attribution rules in determining dividend equivalency under § 302(b)(1) despite claims of family hostility); Swennes, " 'Not Essentially Equivalent to a Dividend' Exception Still Viable Despite *Davis*," 41 J. Tax. 78, 82 (1974) (family discord "is one instance in which attribution rules might be waived"); Note, 16 Vill.L.Rev. 88, 105 (1970) (cases holding that family discord may enter into application of "not essentially equivalent to a dividend test" still good law after *Davis*).

of a program to terminate the involvement of the wife's family in the corporation. The IRS applied the attribution rules. Since the percentage of shares constructively owned by each of the trusts increased after the redemption, the IRS determined that the payment to the trusts was ordinary income. The Tax Court upheld the Commissioner. The First Circuit, however, directed the Tax Court "to reconsider taxpayers' claims in the light of the facts and circumstances of the case, including the existence of family discord tending to negate the presumption that taxpayers would exert continuing control over the corporation despite the redemption." *Id.* at 48.

For the most part, courts and commentators who urge that *Davis* leaves open the family discord question have emphasized that the *Davis* Court, despite its preference for objective tests, defined the "essentially equivalent to dividend" test in open-ended terms. "[T]o qualify for preferred treatment under [§ 302(b)(1)], a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation." 397 U.S. at 313, 90 S.Ct. at 1048. In *Robin Haft Trust*, the First Circuit concluded that "[t]his language certainly seems to permit, if it does not mandate, an examination of the facts and circumstances to determine the effect of the transaction transcending a mere mechanical application of the attribution rules." 310 F.2d at 48. Several commentators have similarly interpreted the "meaningful reduction" language.[10]

These interpretations are not persuasive. The *Davis* Court was referring to a meaningful reduction in the shareholder's interest *after* application of the attribution rules.[11] It would be strange indeed if what the Court really meant

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[10]O'Dell & Boyd, *supra* note 9 at 156; Note, *supra* note 9 at 105.

[11]One commentary argues that a slight reduction in constructive ownership may be a "meaningful" reduction within the meaning of *Davis* if there is family hostility. Note, *supra* note 9 at 105. That analysis cannot be applied here because there was no reduction in the Trust's constructive ownership. In any event, we think it is a misreading of *Davis*.

was that the attribution rules are to be applied before determining dividend equivalency, but then in the course of determining dividend equivalency their applicability could be reconsidered.[12] If that were so, the attribution rules would hardly "provide a clear answer to what would otherwise be a difficult tax question . . ." 397 U.S. at 306, 90 S.Ct. at 1044.[13]

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[12]As one commentator has noted, "On the one hand, the provisions of section 302 apply the attribution rules without mitigation. On the other hand, the 'essentially equivalent to a dividend' language of the Code and the legislative history of section 302 require a factual determination." Brogan, "The Interaction Between Family Attribution Rules and Corporate Redemptions," 31 Case W.L.Rev. 304, 313 (1981). In this commentator's view, the statute provides conflicting guidance. Therefore, he argues that family disharmony *may* mitigate application of the attribution rules. *Id.* at 313-319. We think this analysis is wrong. The two statutory provisions can easily be reconciled if one recognizes that, while the "factual determination" required by § 302(b)(1) may take many factors into account, it must accept the attribution rules as given.

We are more convinced by the following analysis:

> Although the *Davis* Court did not call for a mechanical application of the attribution rules in so many words, it did observe that the rules were designed to 'provide a clear answer to what would otherwise be a difficult tax question.' This statement indicates the Court's desire to avoid having to analyze the hostility or amicability in the section 318 relationships in each case. Indeed, *Davis* rejected the use of other subjective criteria, such as business purpose or tax-avoidance motives, in determining dividend equivalence under section 302(b)(1). It is doubtful that the Court would proscribe some subjective inquiries but at the same time approve ad hoc determinations of section 318's application to section 302(b)(1).

Postelwaite & Finneran, "Section 302(b)(1): The Expanding Minnow," 64 Va.L.Rev. 561, 592 (1978).

[13]The Commissioner argues that *Haft Trust* is in any event distinguishable because the attribution in the present case is not across unfriendly lines. Jacob Metzger was the trustee of the David Metzger Trust; thus according to the Commissioner attribution from him and his dependents to the Trust did not raise an issue of family hostility.

Legislative History of § 302(b)(1)

The Trust also points to the legislative history of §§ 302 and 318. It is not necessary to traverse a long and complicated history here. Section 302's predecessor was a single dividend equivalency test. It had been interpreted flexibly, so that a redemption with a legitimate business purpose was treated as not "essentially equivalent to a dividend." In 1954 the House version of § 302 contained only the safe harbors of § 302(b)(2) ("substantially disproportionate redemption") and § 302(b)(3) ("termination of shareholder's interest"). The Senate added § 302(b)(1), the old essential equivalency test, because the House rules "appeared unnecessarily restrictive." S.Rep. No. 1622, 83d Cong., 2d Sess. 44, *reprinted* in 1954 U.S.Code Cong. & Ad.News 4621, 4675. Thus, several commentators have argued that Congress meant to reinstate subjective inquiry.[14] In *Davis*, however, while conceding that "[t]he intended scope of § 302(b)(1) as revealed by this legislative history is certainly not free from doubt," 397 U.S. at 311, 90 S.Ct. at 1047, the Court concluded that Congress was rejecting past decisions that looked to motive. Section 302(b)(1) was not intended to be a mechanical test, but it was not intended to be a subjec-

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We are not convinced by this argument and prefer not to rely on it. The proceeds of the redemption went not to Jacob but to his sisters. Therefore, if the attribution rules are to be applied flexibly, ownership of the shares held by the Trust should be attributed to the sisters and not to Jacob. Either a flexible application of § 318(a) is appropriate or it is not. The IRS cannot have it both ways.

It is arguable that this Court approved *Haft Trust* and the family hostility exception to the attribution rules when it decided *Rickey v. United States*, 592 F.2d 1251 (5th Cir. 1979). In a footnote to its opinion, this Court rejected the contention that since *Davis* family hostility could no longer be a relevant circumstance in determining dividend equivalency. "We do not agree with that interpretation as *Davis* involved no claim of family hostility," the Court said. *Id.* at 1257 n. 6. We are free to disregard dictum and do so here.

[14]Brogan, *supra* note 12 at 312; Holden & Serling, "Section 302 Redemptions: New Principles and Prospects," 11 Cum.L.Rev. 553, 556 (1980).

tive test, either. Rather, Congress intended "a factual inquiry," "devoted solely to the question of whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation." S.Rep. No. 1622, 83rd Cong., 2d Sess., *reprinted in* 1954 U.S. Cong. & Ad.News 4621, 4870-4871. The Senate Report adds that "the presence or absence of earnings and profits of the corporation is not material" to dividend equivalency. *Id.* at 4871. If so, motive could hardly be material since in the absence of earnings there would be no motive to seek capital gain treatment. The issue, as the *Davis* Court said, was not the taxpayer's motive but whether there was "a meaningful reduction of the shareholders proportionate interest in the corporation." 397 U.S. at 313, 90 S.Ct. at 1048.[15]

We return to the first level of the Trust argument — that attribution bottomed as it is on assumed family unity ought not to be applied when the assumption is contrary to stipulated fact. Nothing in the legislative history suggests that the attribution rules are to be "mitigated" in special cases. On the contrary, the Senate Report states that "the rules for constructive ownership of stock section 318(a) shall apply for purposes of this section generally." S.Rep. No. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S. Cong. & Ad.News 4621, 4872. Neither the language of the statute, the Supreme Court's opinion in *Davis*, nor the legislative history supports treating the attribution rules as rebuttable presumptions as the Trust is seeking.

Under the Trust's approach the Commissioner and the courts would be forced to highly case specific inquiries into elusive fact patterns. The pattern, intensity, and predicted duration of a family fight are difficult enough for the solomonic justice of our domestic relations courts. It is hardly

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[15]One commentator has described the *Davis* test as "a yet undetermined *objective* standard." Comment, "Stock Redemption and the Test for Dividend Equivalency Under Section 302(b)(1) of the Internal Revenue Code of 1954," 23 U.Fla.L.Rev. 188, 194 (1970) (emphasis added). We think this is an accurate characterization.

the basis for a soundly administered tax policy. The fixity of the attribution rules then in this sense is not their weakness but their strength.

In summary, we believe that the Commissioner and Tax Court were correct in refusing to take family discord into account in applying the attribution rules.[16] When a question is raised as to the dividend equivalency of a redemption, under § 302(b)(1) the correct approach is to apply the attribution *rules* first, then to determine whether there has been "a meaningful reduction of the shareholder's proportionate interest," without regard to whether the interest is actually or constructively held. What is "meaningful" then, to borrow a word, is essentially an inquiry into structure, a structure that applies statutorily dictated rules of economic unity.

(c) *Waiver of Attribution by Trusts?*

[2] The Trust's second contention is that it executed a waiver agreement that met the requirements of § 302(c)(2)(A)(iii) and hence qualified for the statutory exception to the attribution rules. This contention presents the question whether a trust may "waive" attribution of ownership even though § 302(c)(2)(A)(iii), by its terms, permits only attribution of ownership to *individuals* to be waived.[17] Our resolution of this issue will not have a lasting effect on the law of this circuit, because section 228 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub.L. No. 97-248, 96 Stat. 324, has amended § 302(c)(2) prospectively so as to expressly prohibit waivers of attribution to and from entities

[16]The Tax Court in its opinion below did suggest that in cases of non-pro-rata distribution family hostility "can be a relevant fact to be considered in determining whether the reduction in the shareholder's interest is meaningful so as to qualify the distribution as not essentially equivalent to a dividend under section 302(b)(1)." 76 T.C. 42, 62-63 (1981). That notion is inconsistent with our approach. Regardless, such a case was not presented below or here.

[17]Section 302(c)(2) states that the attribution rules of *section 318(a)(1)* shall not apply if certain conditions are met. The attribution rules relating to trusts are contained in 318(a)(2) and 318(a)(3).

(including trusts).[18] But it will have an impact on the Metzgers and perhaps on the tax jurisprudence of this circuit.

Rickey

Our analysis of the waiver issue must focus upon this court's decision in *Rickey v. United States*, 592 F.2d 1251 (5th Cir.1979). There we permitted an estate that had been required to redeem stock in accordance with the company's articles of incorporation and the instructions in decedent's will to file a waiver of the attribution rules. The facts in *Rickey* were exceptional. The decedent, Horace Rickey, Sr., had owned over 57% of the corporation's stock. Most of the remaining stock was held by his children. When he died, a provision of the articles of incorporation required that his stock be redeemed by the corporation. Horace Sr.'s will also directed that the shares be tendered to the corporation. This left most of the stock after the redemption in the hands of the three children. However, those children were also the residuary legatees under Horace Sr.'s will. Therefore, with the application of the attribution rules, the estate remained the constructive owner of a controlling interest in the corporation after the redemption. The Commissioner assessed taxes at ordinary income rates. Although the estate had executed a waiver agreement, the Commissioner refused

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[18]Section 228(a) outlines procedures by which entities may waive attribution from *individuals* to *individuals*. The conference committee report states, "Under the bill, only family attribution under section 318(a)(1) may be waived by an entity and its beneficiaries. The waiver rules would not be extended to waivers of attribution to and from entities and their beneficiaries (secs. 318(a)(2) and 318(a)(3))." H.R.Rep. No. 760, 97th Cong., 2d Sess. 545 (1982). The conference committee expressly disavowed any implied comment as to the pre-TEFRA status of entity waiver: "The conferees intend that the bill should not be construed to provide any inference as to whether the *Rickey* decision [discussed *infra*] adopts a proper construction of present law. Nor is any inference intended as to whether the other cases extending the waiver rules for family attribution to entities adopt a proper construction of present law." *Id.* at 545-546.

to recognize the waiver because § 302(c) (2) (A), by its terms, only permitted waiver of attribution to individuals.

Responding to what it perceived as an "inappropriately harsh result[ ]," this Court held that the estate could file a waiver of the attribution rules. 592 F.2d at 1258. While conceding that "the literal language of the statute" dictated a different result, this Court reasoned that permitting an estate to waive attribution in the circumstances of the case was "more in consonance with the intent of Congress in enacting these sections." *Id.*

Rickey has been heavily criticized by courts and commentators. They have pointed out that it is contrary to the language of § 302(c) (2) (A), which permits waiver only of attribution to individuals; that it misreads the legislative history, which confirms what the statute itself says; and that it introduces undesirable uncertainty into tax planning.[19] One may also question *Rickey's* consistency with *Davis.*[20] *Rickey*, however, is the law of the Fifth Circuit, and this panel is obligated to follow it.

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[19] *See* the Tax Court's opinion below, 76 T.C. 42, 68-72 (1981). *See also Henry Patterson Trust v. United States,* No. C80-145, slip op. at 10-14 (N.D. Ohio 1982), wherein the court held that a trust could not effectively waive the beneficiary-to-trust attribution rules.

See Comment, "Estate Waiver of the Estate-Beneficiary Attribution Rule in Nonliquidating Redemptions Under Section 302 and Related Matters: The *Rickey* Case in the Fifth Circuit," 35 Tax L.Rev. 147, 151, 154, 162-163 (1979); Note, "Stock Redemptions and the Estate Attribution Rules," 128 U.Pa.L.Rev. 650, 665-667 (1980); Karzon, "No Smooth Sailing for Fiduciaries Waiving Attribution in Stock Redemptions," 59 Taxes 3, 6 (1981). *But see* Brogan, *supra* note 12 at 326-327.

Both the House and Senate reports repeatedly refer to waiver of the *family* attribution rules. They do not mention other forms of waiver. See H.Rep. No. 1337, 83d Cong., 2d Sess., *reprinted in* 1954 U.S.Code Cong. & Ad. News 4017, 4061, 4212-4213; S.Rep. No. 1622, 83d Cong., 2d Sess., *reprinted in* 1954 U.S.Code Cong. & Ad.News 4621, 4676, 4872-4873.

[20] *See* Comment, *supra* note 19 at 162.

Rickey and Trusts

We are not, however, obligated to extend *Rickey*. There are sufficient differences between waiver by an estate and waiver by a trust to justify different rules. An estate is in many senses a continuation of the decedent. A person can "create" only one estate, and that estate does not come into existence until the person's death. Thus, assuming Horace Rickey, Sr., could have filed a waiver agreement on his deathbed, there seems to be little difference, in tax theory, if his estate files the waiver.[21] Section 302(c)(2)(A) is designed to permit one family member to turn over control of a close corporation to another family member *once* and receive capital gains.[22] Allowing this to occur after the first family member's death does not vitiate the purposes of § 302(c)(2)(A).

Permitting waiver by trusts, however, would run contrary to the purposes of § 302(c)(2)(A). Trusts are completely artificial entities: A person can create any number of them. If a trust could waive attribution, there would be nothing to prevent a settlor, one of the beneficiaries, or a new trust with the same beneficiaries from reacquiring the same interest in the corporation.[23] Ownership of the stock could be shifted

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[21]This is a slight oversimplification. If Horace Sr. had redeemed the stock before he died, he would have had to pay capital gains tax. When the estate redeemed the stock, the basis had been stepped-up to fair market value at the time of death. I.R.C. § 1014(a).

[22]The ten-year "look back" and "look forward" provisions, §§ 302(c)(2)(B) and (c)(2)(A)(ii), basically guarantee that transfer from one family member to another may only occur once a generation.

[23]Commentary has focused on whether beneficiaries of a trust would be bound by a trust's waiver agreement and thus could not acquire any interest within 10 years of the date of distribution. *Rickey* itself did not deal with this issue. *See* Holden & Serling, *supra* note 14 at 568. Most commentators have concluded that the beneficiaries would not be bound. Comment, *supra* note 19 at 155-156. Moreover, a rule permitting waiver by a trust so long as the waiver was binding on the beneficiaries would not help the Trust in the present case. Jacob was one of the beneficiaries of the David Metzger Trust, yet he retains a controlling interest in Metzger Dairies.

from trust to trust, from trust to beneficiary, or from beneficiary to trust, without any change in the family member who actually controls the corporation. The potential for abuse would be great.[24]

It is true that the parties have stipulated here to an absence of tax-avoidance motive. This, however, emphasizes the dangers of permitting waiver of attribution by a trust. To prevent a bail-out of corporate earnings, the Commissioner and the courts would have to delve deeply into motive. *Davis*, however, condemns such an approach. 397 U.S. at 309, 90 S.Ct. at 1046 ("the authors of the new Code sought to provide objective tests to govern the tax consequences of stock redemptions"). Moreover, even an unblemished motive at the time of redemption is no guarantee that the parties who have bailed out will not bail back in later. A rule permitting waiver by estates is consistent with the underlying rationale of waiver and can be accommodated without an inquiry into the taxpayer's motive. A trust waiver rule, on the other hand, is inconsistent with the rationale of waiver and would require a troublesome inquiry into motive. Accordingly, we hold that as to pre-TEFRA redemptions, a trust may not file an effective waiver agreement pursuant to § 302(c)(2)(A).

Having concluded that family hostility does not mitigate the application of the attribution rules in determining dividend equivalency, and that a trust may not waive those rules, we therefore reach the conclusion that the deficiency was properly assessed against the Trust. The second issue raised by this appeal is the appropriateness of interest deductions claimed by Metzger Dairies.

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[24]It is worth noting that one commentator who is favorable to the *Rickey* decision does not believe it can be extended to trusts. "The rationale underlying the decision . . . seems to limit its application to estates." Brogan, *supra* note 12 at 327. This commentator proposes a legislative change permitting statutory waiver by estates, not by trusts. *Id.* at 333-334.

THE CORPORATION'S APPEAL

[3] Section 267 of the Code disallows deductions for certain transactions between related taxpayers. The underlying philosophy of § 267(a)(2), the subsection at issue here, is that related taxpayers should not be able to generate tax deductions in a given year without corresponding income. Metzger Dairies as an accrual basis taxpayer claimed deductions for amounts that were not actually paid to Cecelia until more than 2½ months after the close of its fiscal year. Cecelia, as a cash basis taxpayer, did not report those amounts as income until the following taxable year. Therefore, if Metzger Dairies and Cecelia were related taxpayers within the meaning of § 267, Metzger Dairies was not entitled to certain interest deductions.[25]

Section 267(b) defines the relationships covered by § 267(a). These include "[a]n individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual." § 267(b)(2). Section 267(c), however, provides that "[f]or purposes of determining, in applying subsection (b), the ownership of stock . . . (2) [a]n individual shall be considered as owning the stock owned, directly or indirectly, by or for his family." Section 267(c)(4) defines the family of an individual as including his brothers and sisters. Therefore, putting § 267(b), § 267(c)(2), and § 267(c)(4) together, Cecelia and Metzger Dairies (since Jacob owned a controlling interest in the corporation after the redemption[26]) were related persons within the meaning

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[25]Section 267(a)(2) sets forth three conditions that must be met for disallowance of the interest deduction. First, the interest otherwise deductible must not have been paid within 2½ months of the close of the taxpayer's taxable year. § 267(a)(2)(A). Second, the interest must not, unless paid, be includible in the income of the recipient for the same taxable year. § 267(a)(2)(B). Third, the taxpayer and the recipient must be related persons within the meaning of subsection (b). § 267(a)(2)(C). Metzger Dairies concedes that the first two conditions were met; the dispute is over the third.

[26]After the redemption, Jacob's actual ownership was 600 of the 1221 outstanding shares. Thus, § 267(c) has to be applied once more

of § 267. If the literal language of § 267 is followed, the Commissioner was correct in disallowing the deductions.

Appellant Metzger Dairies, however, argues that the attribution rules of § 267 should not apply because of family hostility. Metzger Dairies seeks an exception to § 267(c) similar to the family discord exception to § 318(a) sought by the David Metzger Trust.

Metzger Dairies cites no case in support of such an exception. In fact, Metzger Dairies cites no case in support of any non-statutory exception to § 267. On the other hand, both the Supreme Court and the Fifth Circuit have read the section in literal terms. In *McWilliams v. Commissioner*, 331 U.S. 694, 67 S.Ct. 1477, 91 L.Ed. 1750 (1947), the Supreme Court held that § 267's predecessor disallowed losses from sales of stock by a taxpayer when his wife simultaneously bought the same stock on the exchange. Although this was a transparent tax-avoidance transaction, the Court spoke generally about the role of § 267's predecessor:

> Section 24(b) states an absolute prohibition — not a presumption — against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic interests. It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and accordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.

Id. 331 U.S. at 699, 67 S.Ct. at 1480.

We recently interpreted § 267 in *Wyly v. United States*, 662 F.2d 397 (5th Cir.1981). There we held that loss deduc-

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(under § 267(c)(1) stock owned by a trust is deemed to be owned proportionately by its beneficiaries) to get Jacob above the 50% figure.

tions were properly denied to parents who had sold stock to trusts set up to benefit their children. Under Texas law, there was a remote possibility that one (or both) of the parents would benefit under the trusts, if all four of the children died first. This possibility was held sufficient to make the parents and the independent trustee "related persons" under § 267(b)(6), which refers to "[a] fiduciary of a trust and a beneficiary of such trust." As we then observed, "There is, in § 267, no language to support the taxpayers' claim that a beneficiary who has only a remote chance of sharing in trust property is not a 'beneficiary' of the trust for purposes of § 267." *Id.* at 402. Likewise, there is no language to absolve Cecelia and Jacob from being family members within the meaning of § 267(c)(4). The *Wyly* court added, "[I]t does not matter whether the transaction is bona fide, at arms length, or in good faith with no tax avoidance motive. Whatever the reason, if the proscribed relationship exists, no loss is recognized for tax purposes." *Id.* at 401.[27]

Metzger Dairies points out that both *Wyly* and *Merritt v. Commissioner*, 400 F.2d 417 (5th Cir.1968), were concerned with § 267(a) and § 267(b). A literal interpretation of §§ 267(a) and (b), it contends, does not foreclose a nonliteral interpretation of § 267(c). Nevertheless, here, as in *Wyly*, the "proscribed relationship" existed. We see no reason for interpreting § 267(c) differently from § 267(b) or § 267(a). Both § 267(b) and § 267(c) are attribution rules, in that they define the circumstances under which a

[27]The Wyly panel also quoted the following passage from *Merritt v. Commissioner*, 400 F.2d 417, 421 (5th Cir. 1968):

We do not read Section 267 as seeking out devils alone. The basic legislative command of that section is that losses incurred from family transactions are not to be taxable events. This blanket approach relieves the taxing authority of many complicated and complex melioristic decisions in family transactions. Although we do not applaud harsh results (though defining the result in this case as 'harsh' would be no easy task), we recognize that simplicity can be a valid congressional rationale for banning transactions by type. 662 F.2d at 402. In *Merritt* we held that a *forced* sale between related taxpayers came within § 267. 400 F.2d at 420.

shared economic interest will be presumed. Congress cannot have intended one subsection to be interpreted literally and the other flexibly. Only a strict interpretation of both provisions is logically consistent. Only such an interpretation will "relieve[] the taxing authority of many complicated and complex melioristic decisions in family transactions." *Merritt v. Commissioner*, 400 F.2d at 421.

In sum, § 267(c) provides constructive ownership rules which "shall" be applied in determining the relatedness of taxpayers. We see no reason to deviate from this express statutory command. Indeed, by our reading, the Fifth Circuit and Supreme Court precedents forbid it. Accordingly, we hold that Metzger Dairies was not entitled to the interest deductions claimed because it and Cecelia were related persons within the meaning of § 267.

CONCLUSION

The courts of appeals have been given the authority to review Tax Court decisions at least in part because it was thought that a generalist's perspective would be helpful; that we are less likely to succumb to the arcane. Yet the avoidance of the arcane must include a recognition of the limits of tax law. It is not a task measured by the chancellor's foot. As understandable as it may be, yielding to the temptation to "do equity" in a specific tax case by looking past plain language to judicially perceived purpose will not do. We do not. We apply *Davis* in full measure, leaving *Rickey* where it was.

AFFIRMED.

In The
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 81-4324

DAVID METZGER TRUST, JACOB METZGER, TRUSTEE, and METZGER DAIRIES, INC.,
Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the Decision of the United States Tax Court

ON SUGGESTION FOR REHEARING EN BANC
(Opinion 12/13/82, 5 Cir., 198 ..., ... F.2d .....).

(JANUARY 26, 1983)

Before THORNBERRY, JOHNSON and HIGGINBOTHAM, Circuit Judges.

PER CURIAM:

(X) Treating the suggestion for rehearing en banc as a petition for panel rehearing, it is ordered that the petition for panel rehearing is DENIED. No member of the panel nor Judge in regular active service of this Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16), the suggestion for Rehearing En Banc is DENIED.

( ) Treating the suggestion for rehearing en banc as a petition for panel rehearing, the petition for panel rehearing is DENIED. The judges in regular active service of this Court having been polled at the request of one of said judges and a majority of said judges not having voted in favor of it (Rule 35, Federal Rules of Appellate Procedure; Local Fifth Circuit Rule 16), the suggestion for Rehearing En Banc is DENIED.

ENTERED FOR THE COURT:

Patt S. Higginbotham
United States Circuit Judge

Internal Revenue Code of 1954, as amended (26 U.S.C.):

SEC. 301. DISTRIBUTIONS OF PROPERTY.

(a) *In General.* — Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

* * * * * *

(c) *Amount Taxable.* — In the case of a distribution to which subsection (a) applies —

(1) *Amount constituting dividend.* — That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) *Amount applied against basis.* — That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) *Amount in excess of basis.* —

(A) In general. — Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

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SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) *General Rule.* — If a corporation redeems its stock (within the meaning of section 317 (b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.* —

(1) *Redemptions not equivalent to dividends.*—

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

* * * * * *

(c) *Constructive Ownership of Stock.* —

(1) *In general.* — Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

* * * * * *

(d) *Redemptions Treated as Distributions of Property.* — Except as otherwise provided in the subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies.

* * * * * *

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK

(a) *General Rule.* — For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable —

(1) *Members of family.* —

(A) In general. — An individual shall be considered as owning the stock owned, directly or indirectly, by or for —

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren and parents.

(B) Effect of adoption. — For purposes of subparagraph (A) (ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

* * * * * *

(3) *Attribution to partnerships, estates, trusts, and corporations.* —

(A) To partnerships and estates. — Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.

(B) *To trusts.* —

(i) Stock owned, directly or indirectly, by or for a beneficiary of a trust (other than an employees' trust described in section 401(a) which is exempt from tax under section 501(a)) shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of this clause, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

(ii) Stock owned, directly or indirectly, by or for a person who is considered the owner of any portion of a trust under subpart E of part I of sub-chapter J (relating to grantors and others treated as substantial owners) shall be considered as owned by the trust.